

HAS THE FIRE BURNED OUT?

The Return to a Normal Market

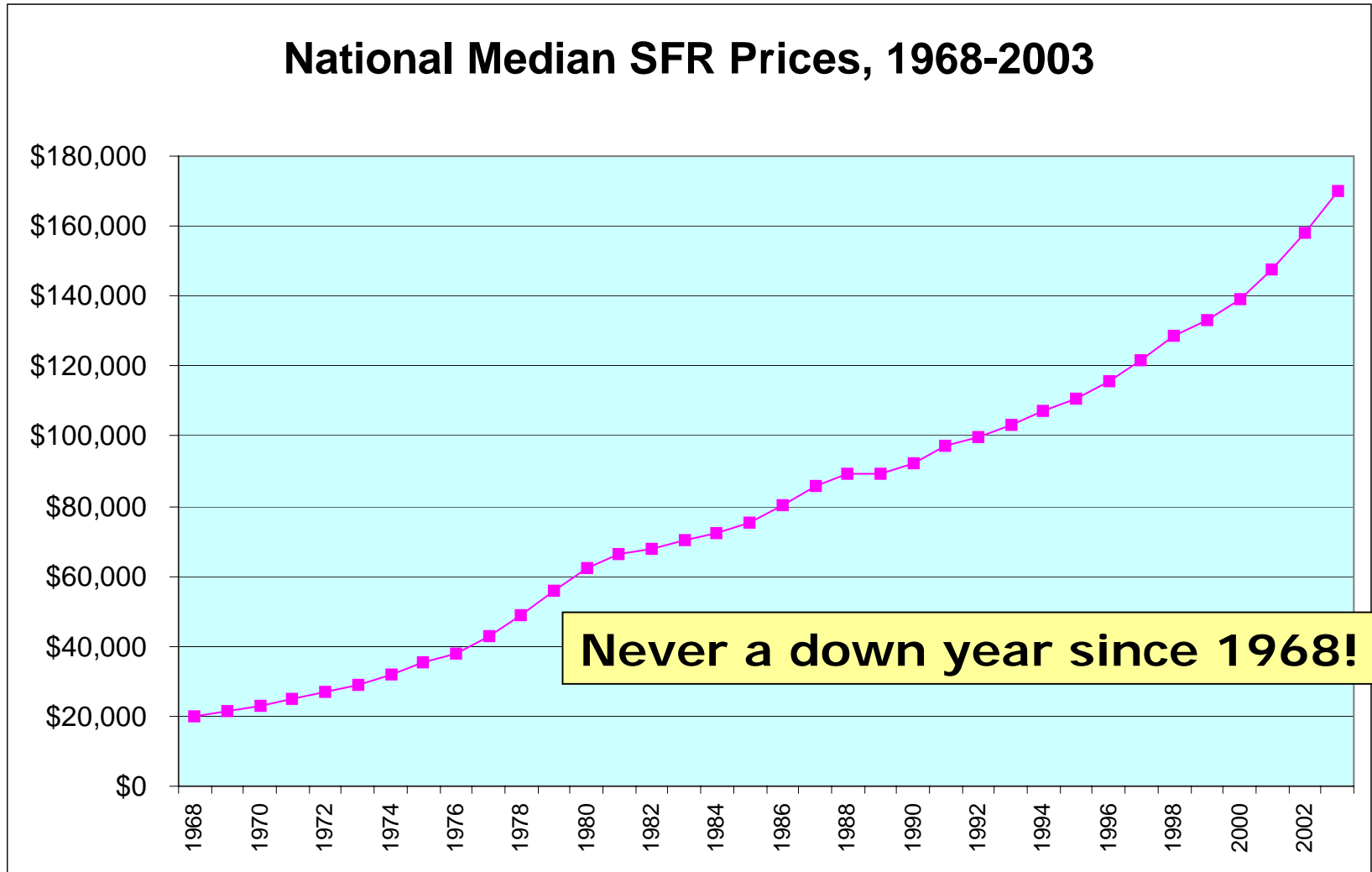
Southern California: An Example Case
A Mathematical Study of Real Estate Trends

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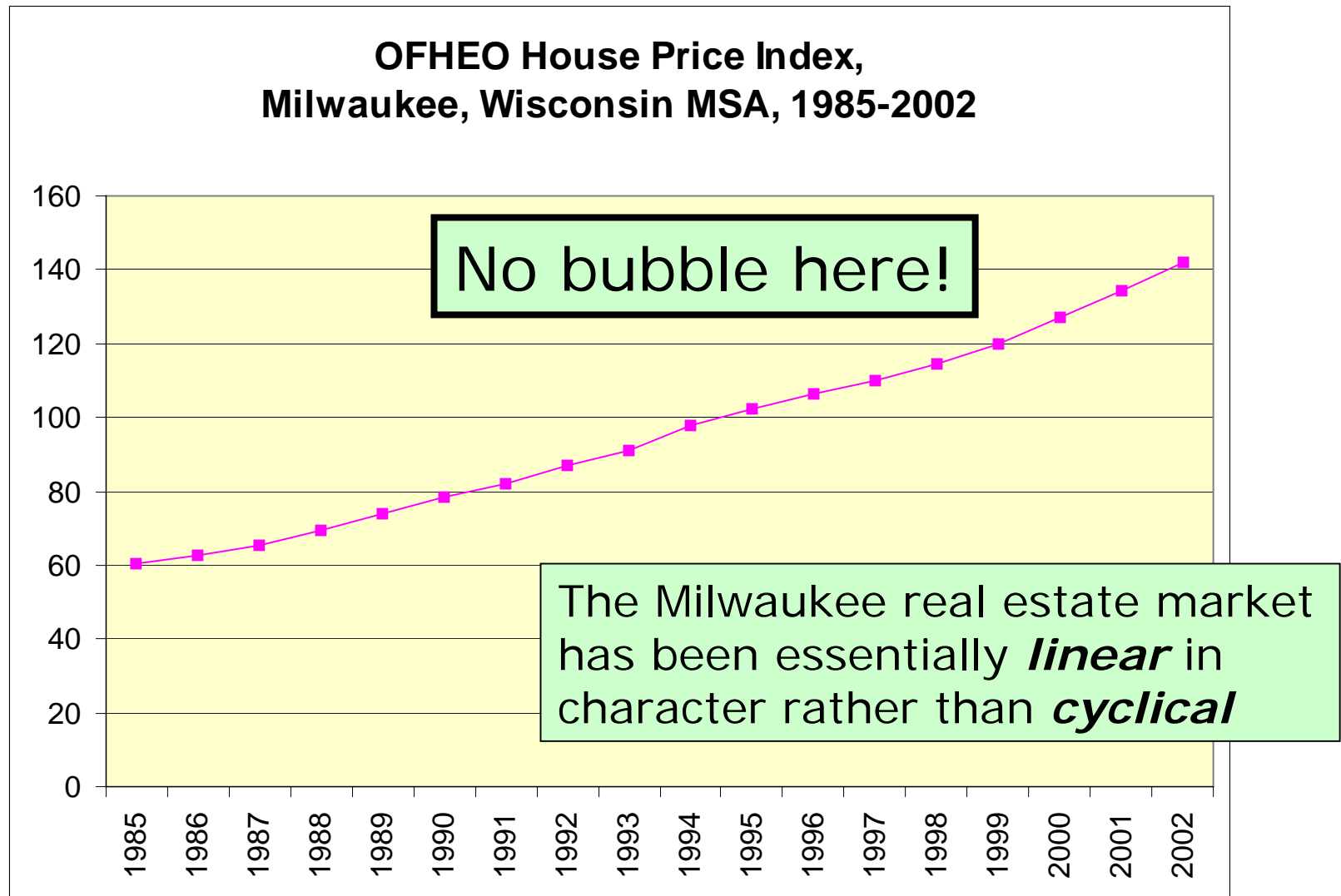
October 27, 2004

The long-term national pattern is very consistent

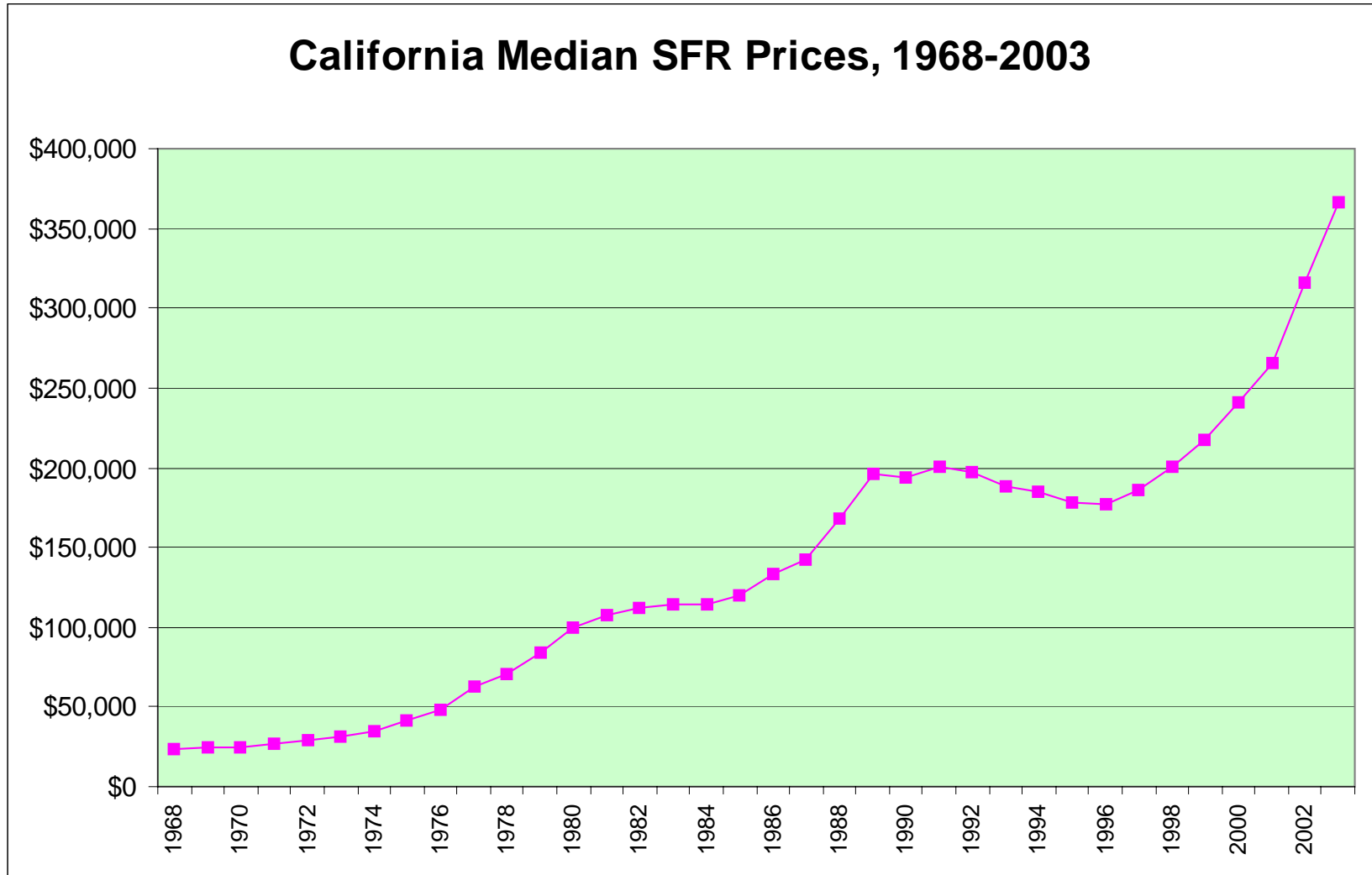


Source: Internal data and National Association of Realtors®

Some markets move smoothly without a cycle



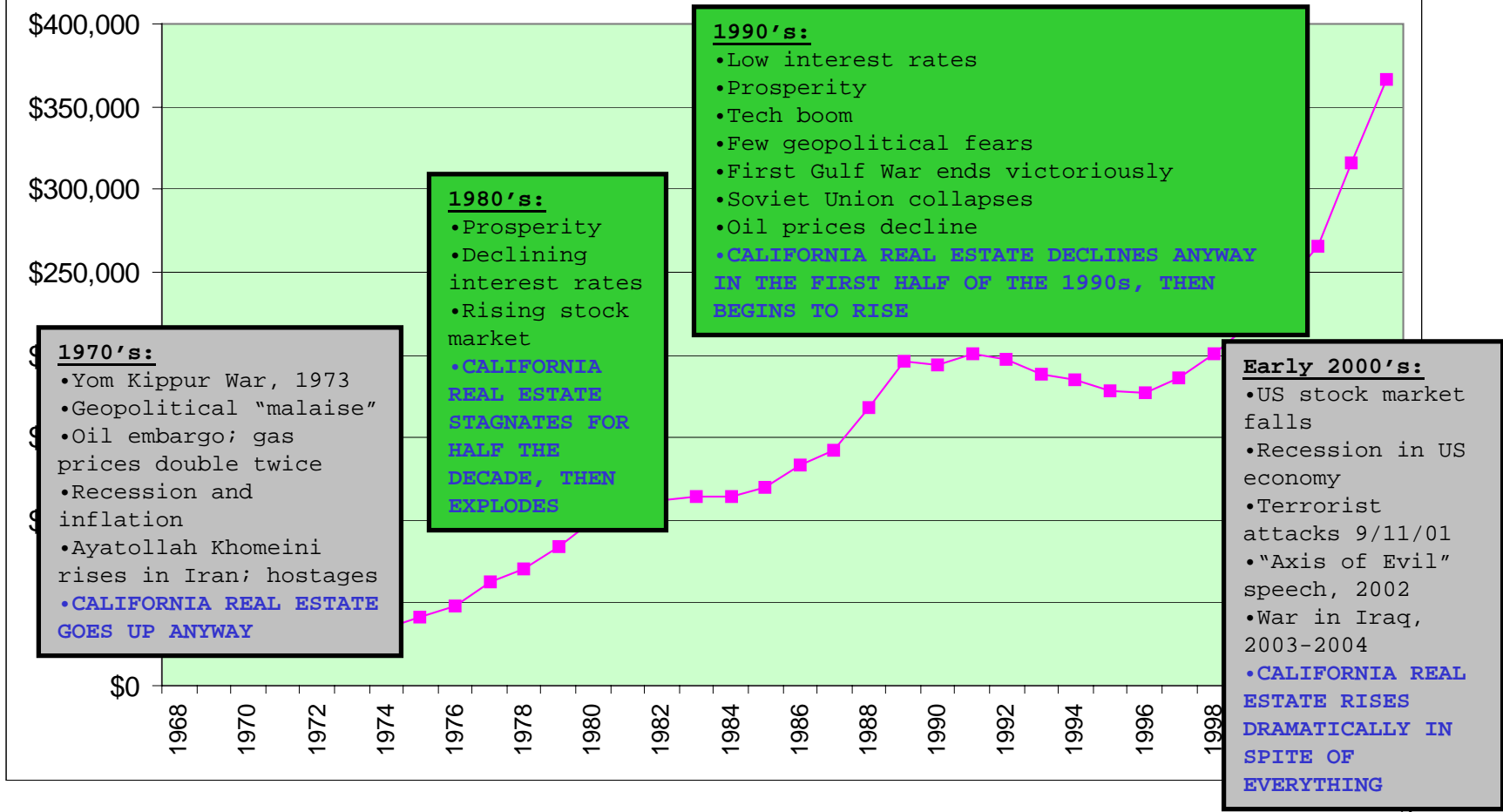
The long-term California pattern is more cyclical



Source: Internal data and California Association of Realtors®

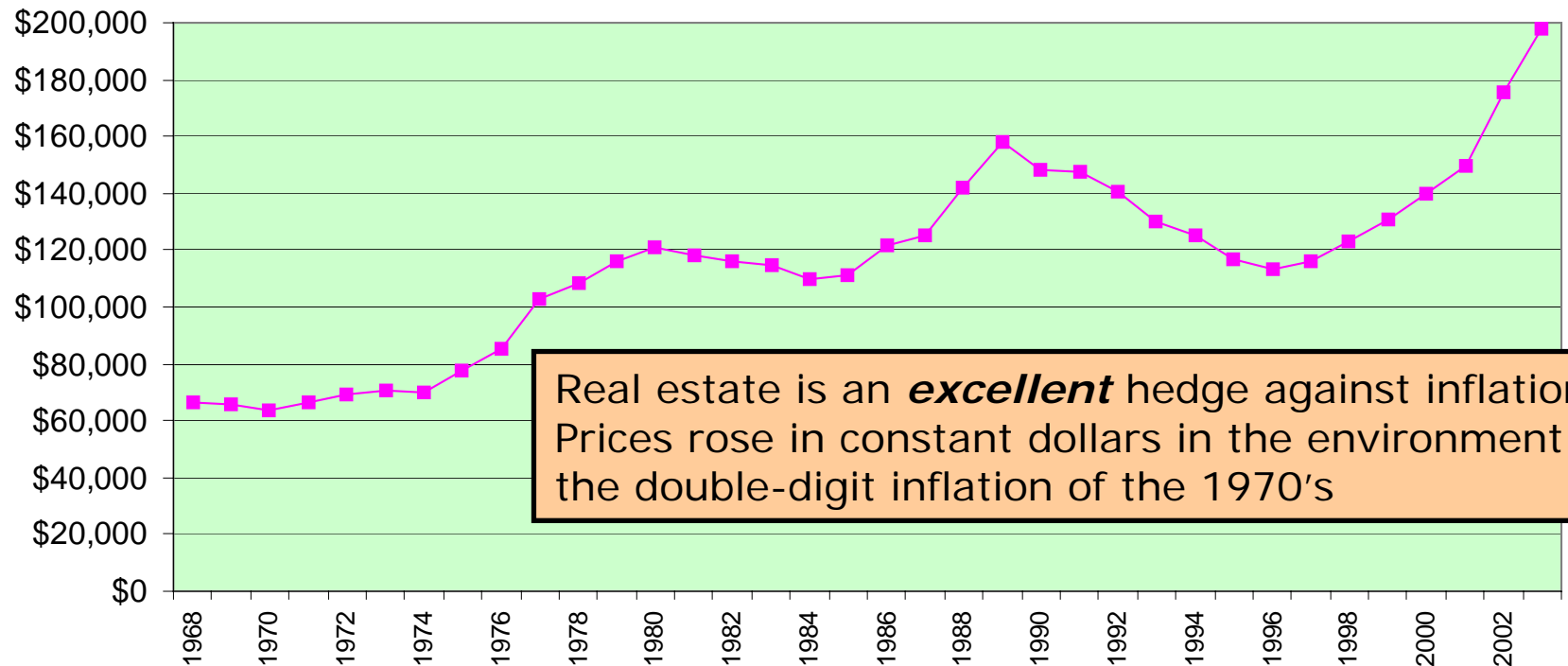
California prices were not driven primarily by geopolitical events, but rather by the economic forces of the market cycle itself

California Median SFR Prices, 1968-2003



After removing the effects of inflation, the cyclical nature of the California market is more apparent

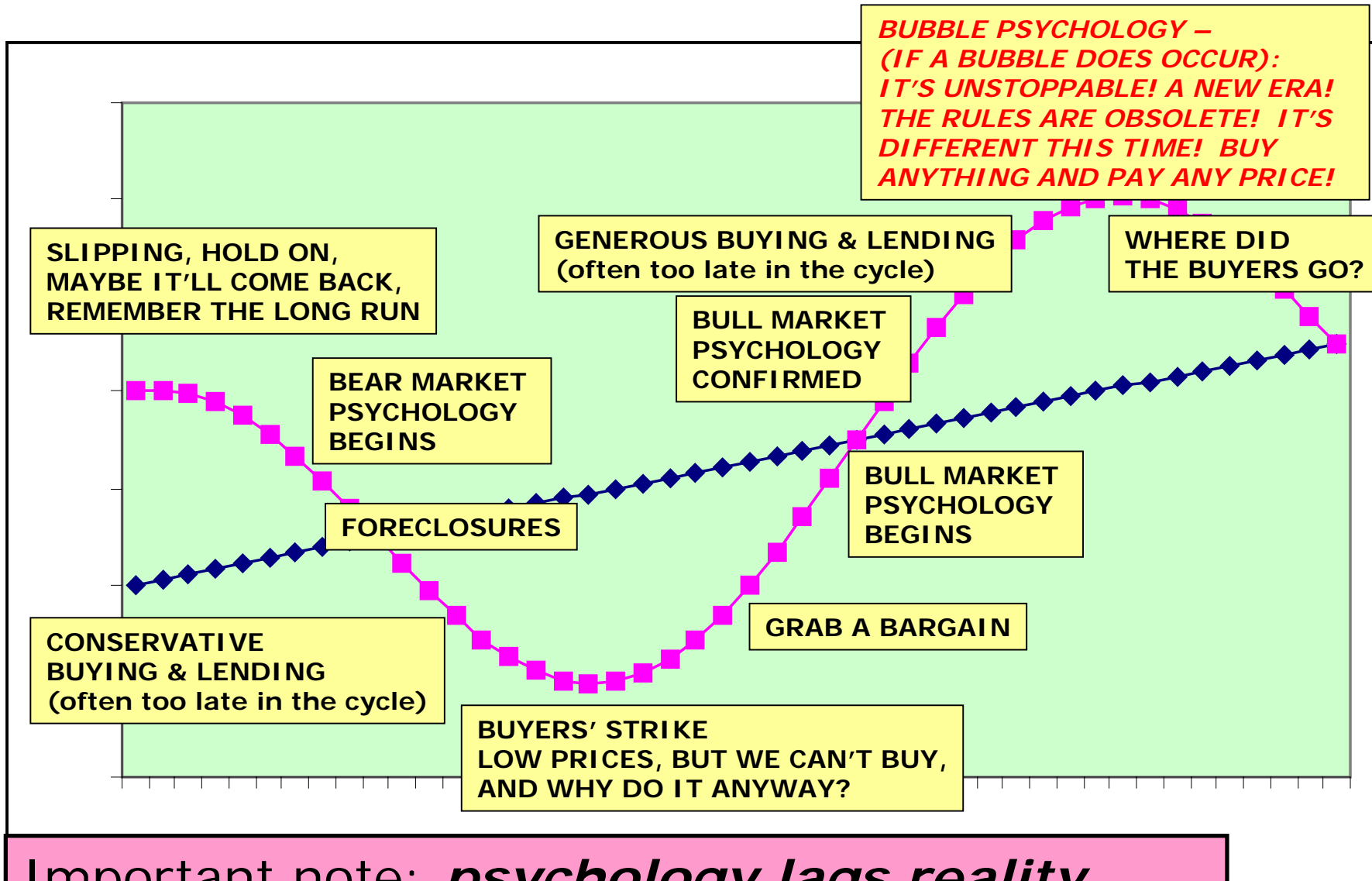
California Median SFR Prices in Constant Dollars (based at 1982-1984)



Real estate is an *excellent* hedge against inflation. Prices rose in constant dollars in the environment of the double-digit inflation of the 1970's

Correction for inflation based on Consumer Price Index (base 1982-1984) published by the Bureau of Labor Statistics

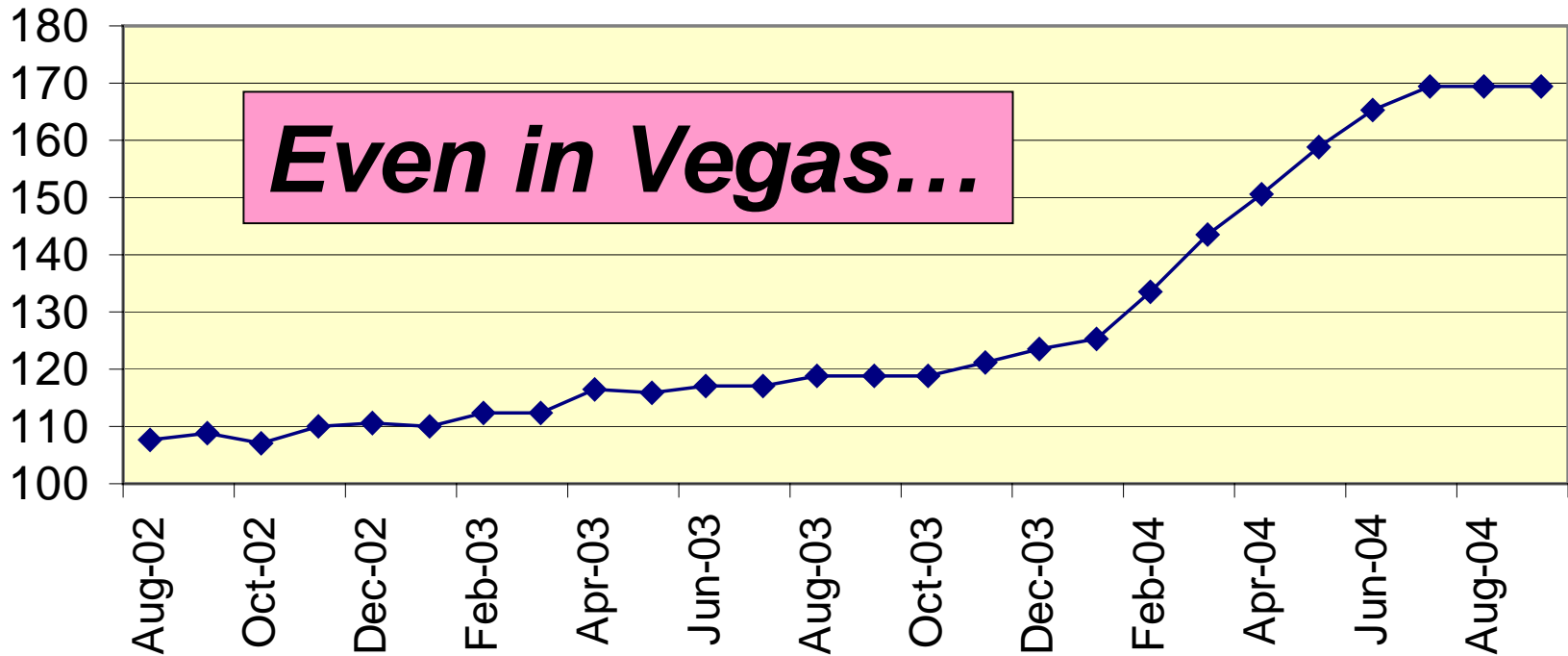
What happens in different parts of the cycle?



Important note: *psychology lags reality*

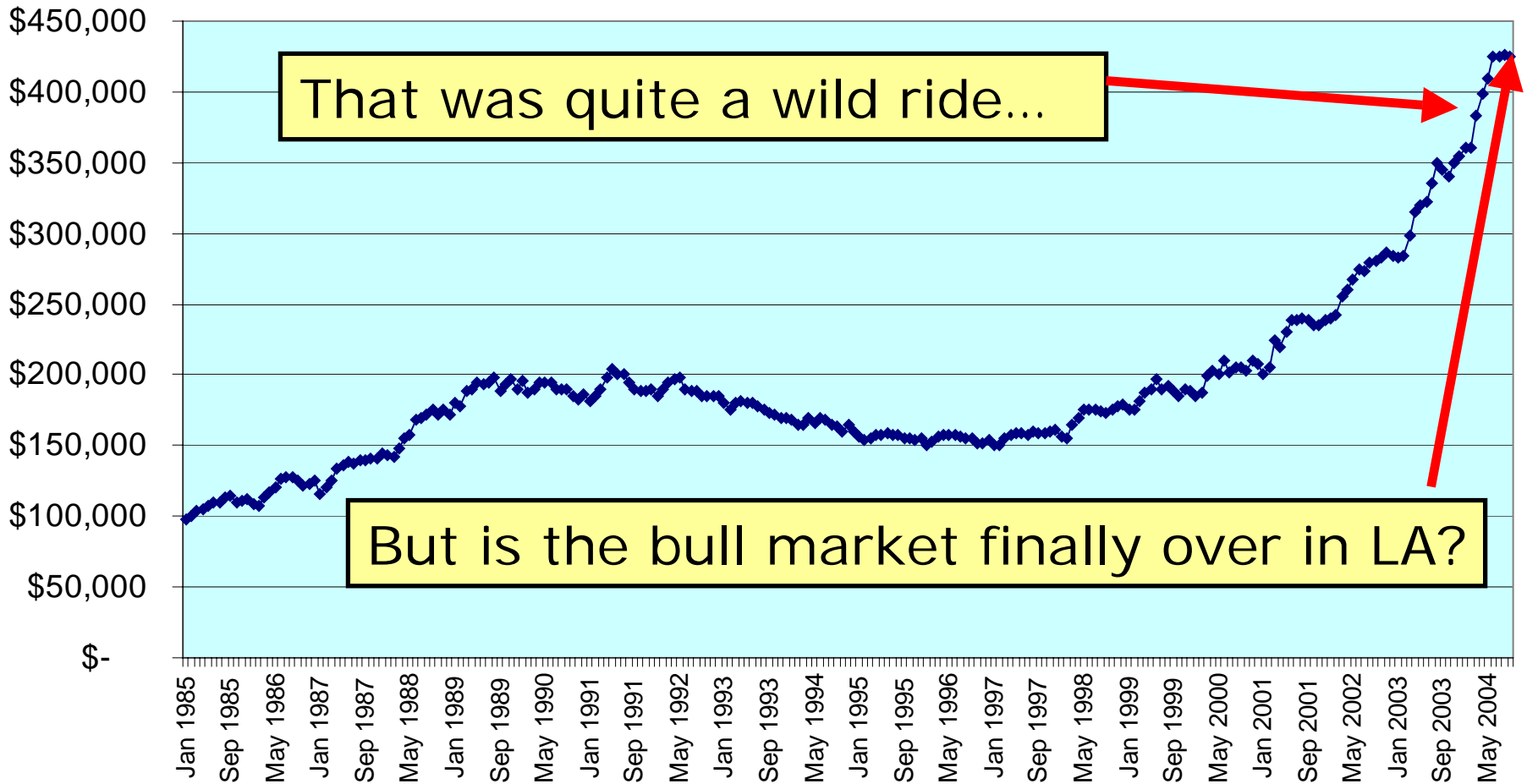
(it takes time for people to become convinced of something)

Price Index, SFRs in Clark County, Nevada August 2002 to September 2004 Based at 2001 = 100



After rising 50% in a single year, prices in Las Vegas have leveled off. Can it be that the great bull market is finally over?

Median SFR Prices, Los Angeles County January 1985 to September 2004



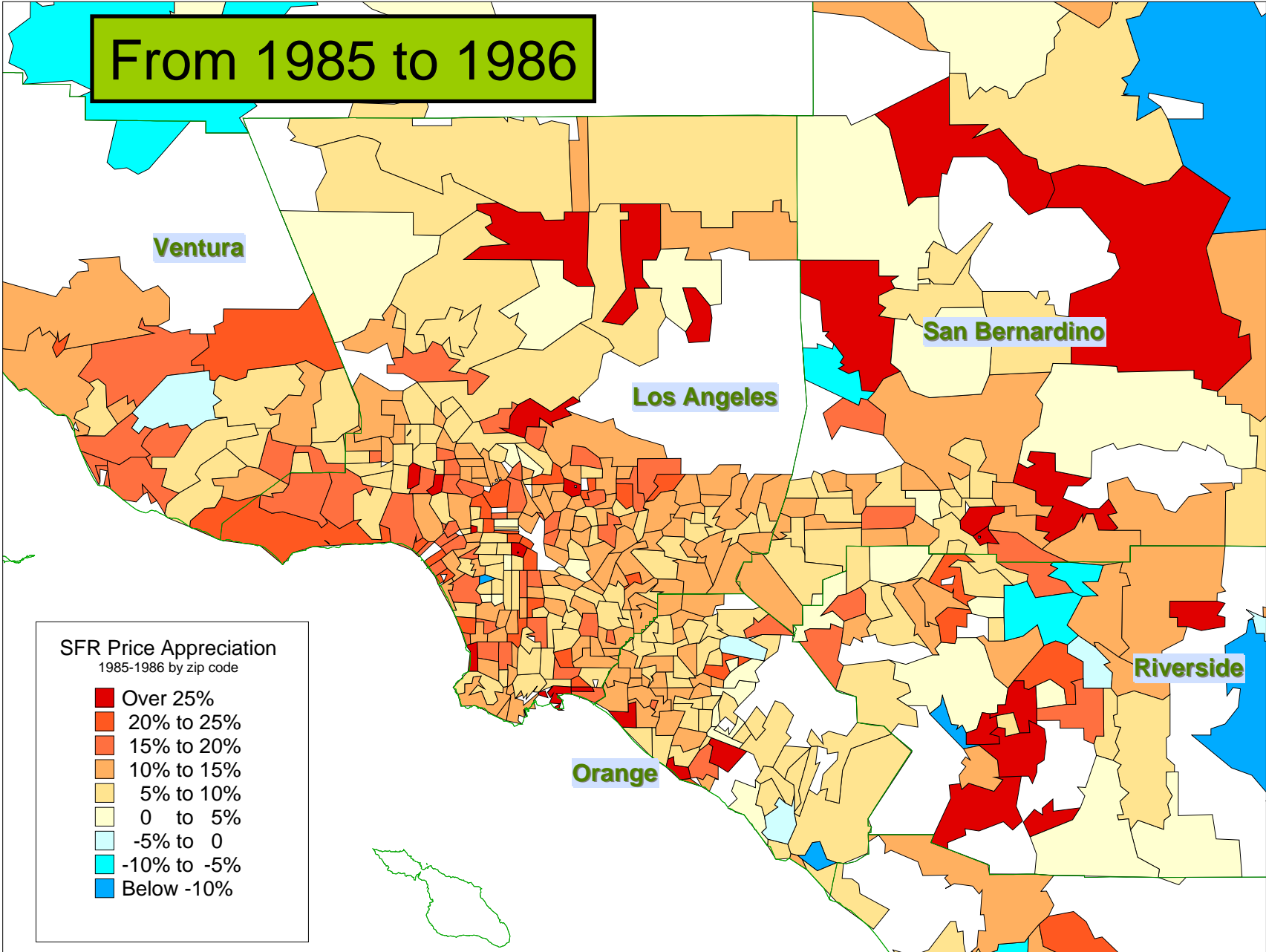
Source: *Real Estate Trends* beta version, First American Real Estate Solutions

Let's use maps to visually see how the real estate business cycle works in Southern California over many years – from 1985 to 2003, studied yearly.

1. These maps display changes in median sale price from year to year, by zip code.
2. The maps do not include zip codes with fewer than 24 arms' length, market-value sales in a year.
3. Zip codes where prices are rising are displayed in hot, red, fiery colors.
4. Zip codes where prices are falling are displayed in cool, blue, icy colors.

Data source: *Real Estate Trends* beta version, First American Real Estate Solutions
Maps prepared from the price data using MapInfo® software.

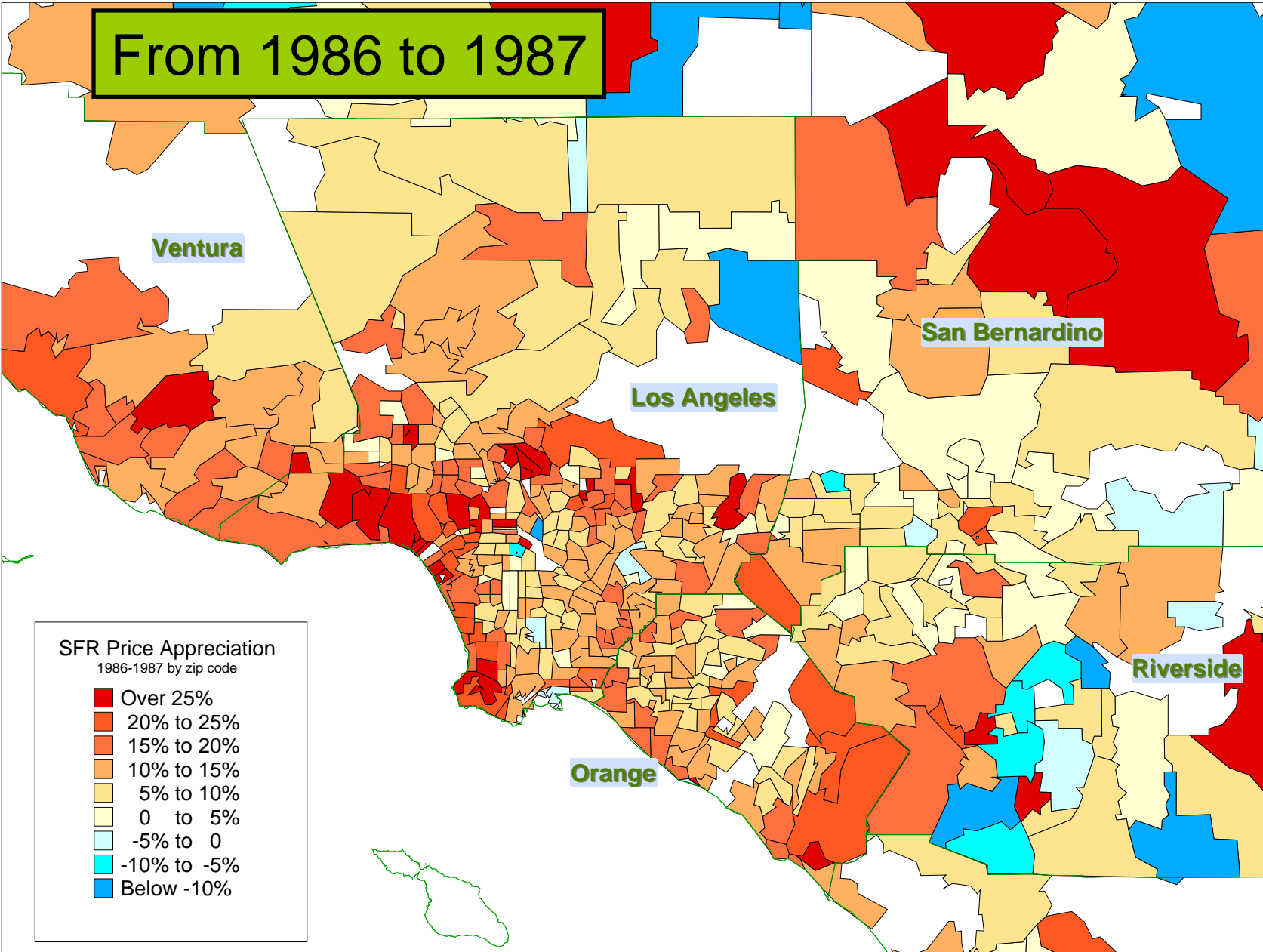
From 1985 to 1986



SFR Price Appreciation
1985-1986 by zip code

- Over 25%
- 20% to 25%
- 15% to 20%
- 10% to 15%
- 5% to 10%
- 0 to 5%
- 5% to 0
- 10% to -5%
- Below -10%

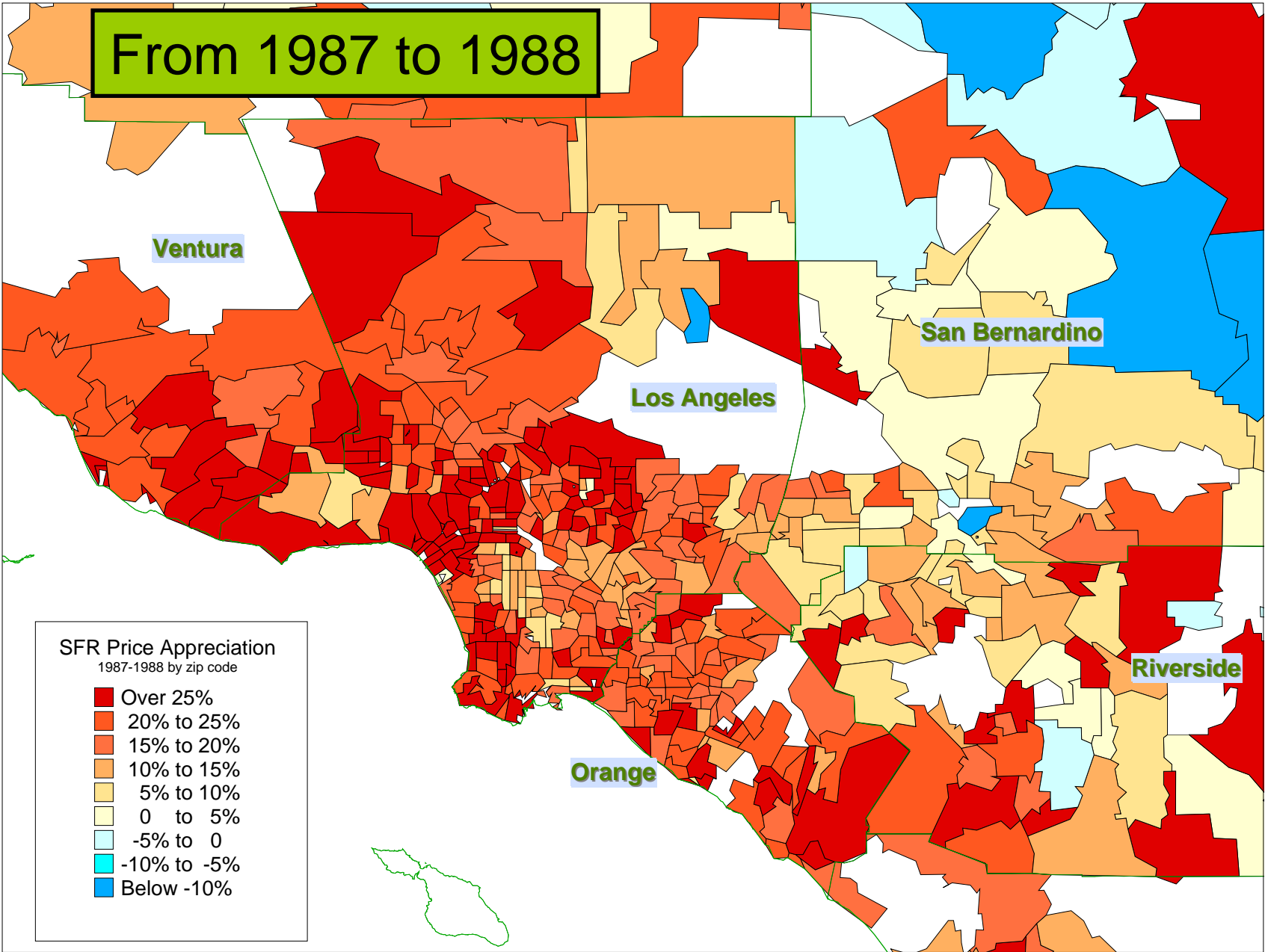
From 1986 to 1987



SFR Price Appreciation
1986-1987 by zip code

- Over 25%
- 20% to 25%
- 15% to 20%
- 10% to 15%
- 5% to 10%
- 0 to 5%
- 5% to 0
- 10% to -5%
- Below -10%

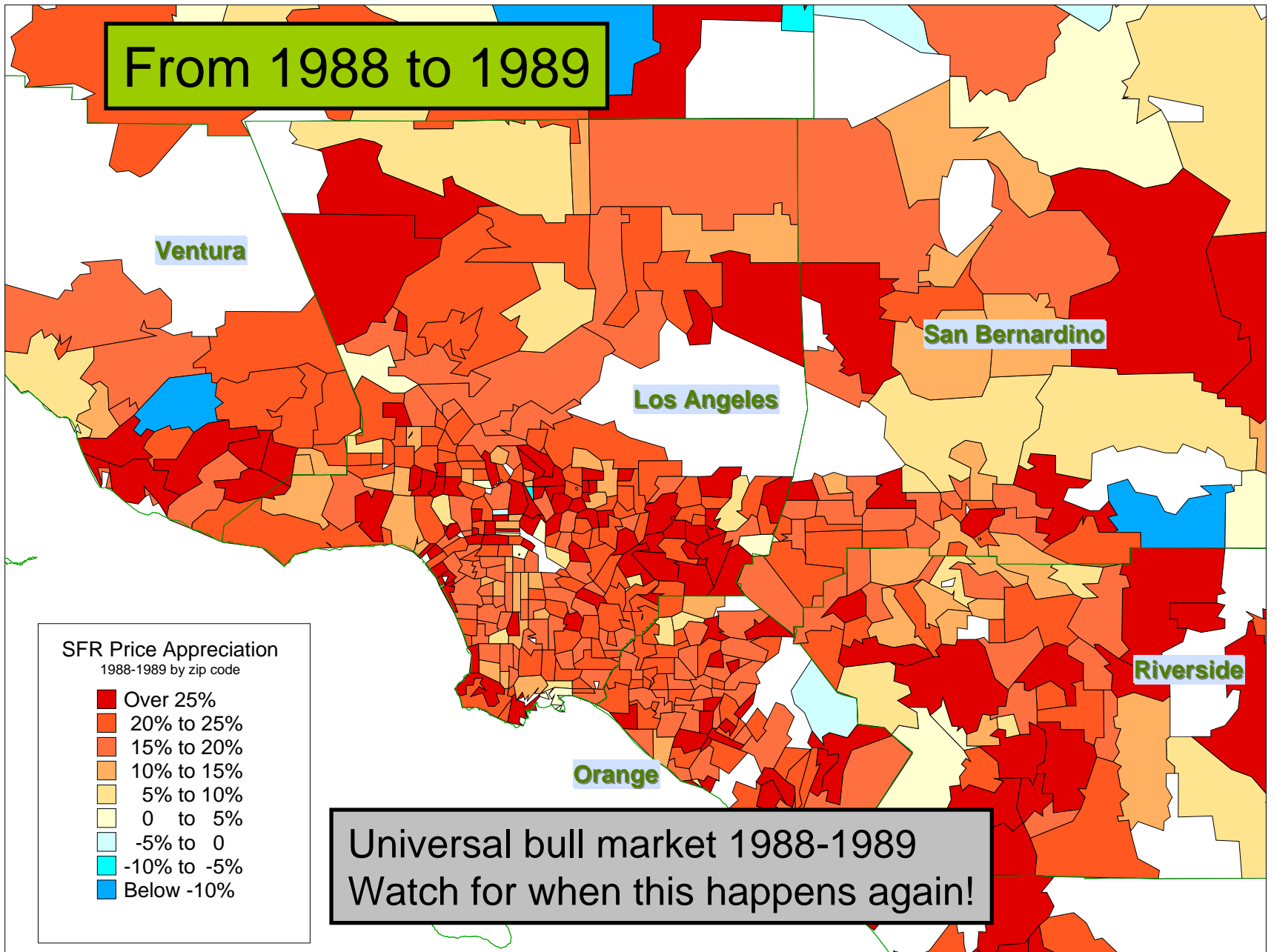
From 1987 to 1988



SFR Price Appreciation
1987-1988 by zip code

- Over 25%
- 20% to 25%
- 15% to 20%
- 10% to 15%
- 5% to 10%
- 0 to 5%
- 5% to 0
- 10% to -5%
- Below -10%

From 1988 to 1989



Ventura

San Bernardino

Los Angeles

Riverside

Orange

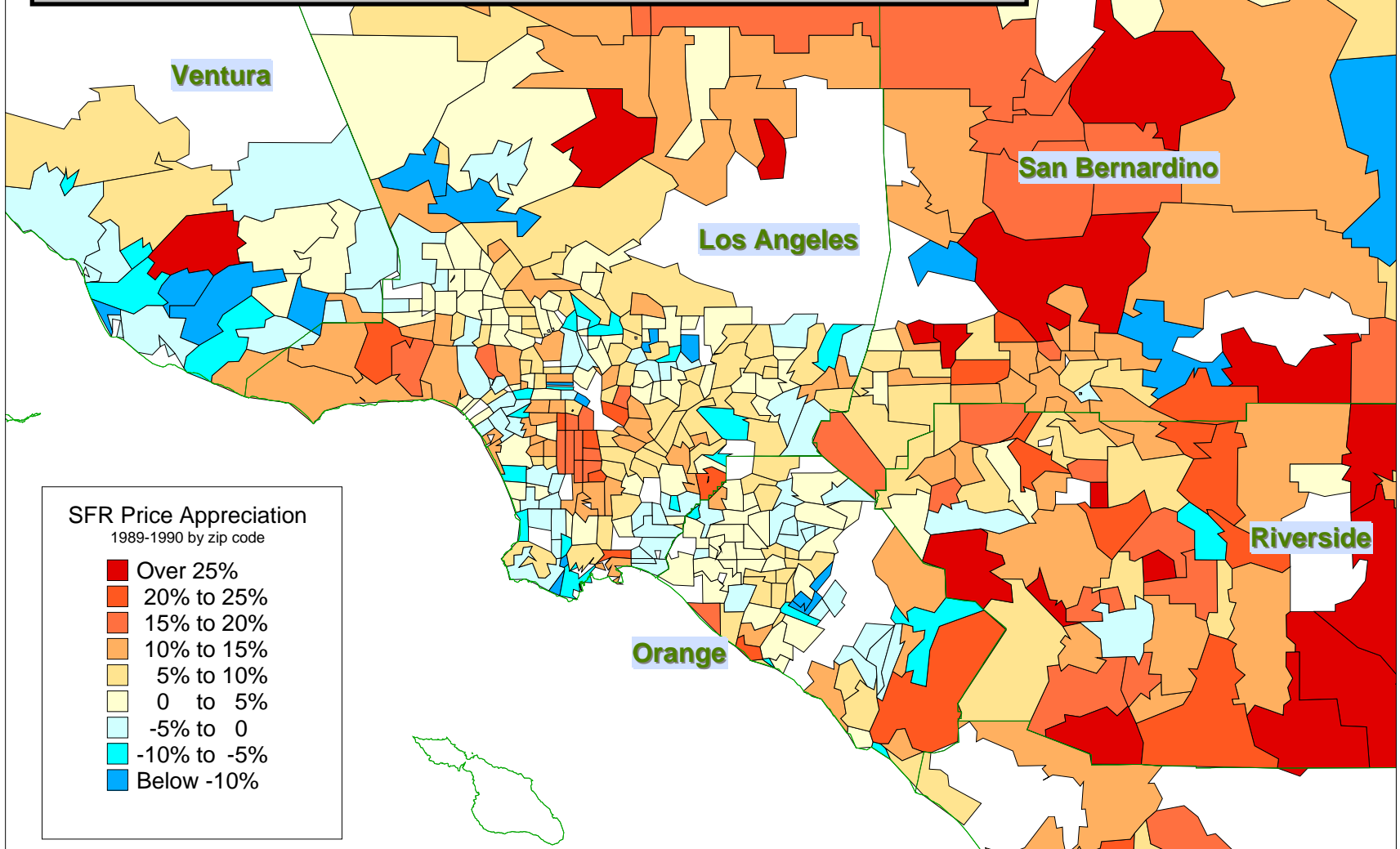
SFR Price Appreciation
1988-1989 by zip code

- Over 25%
- 20% to 25%
- 15% to 20%
- 10% to 15%
- 5% to 10%
- 0 to 5%
- 5% to 0
- 10% to -5%
- Below -10%

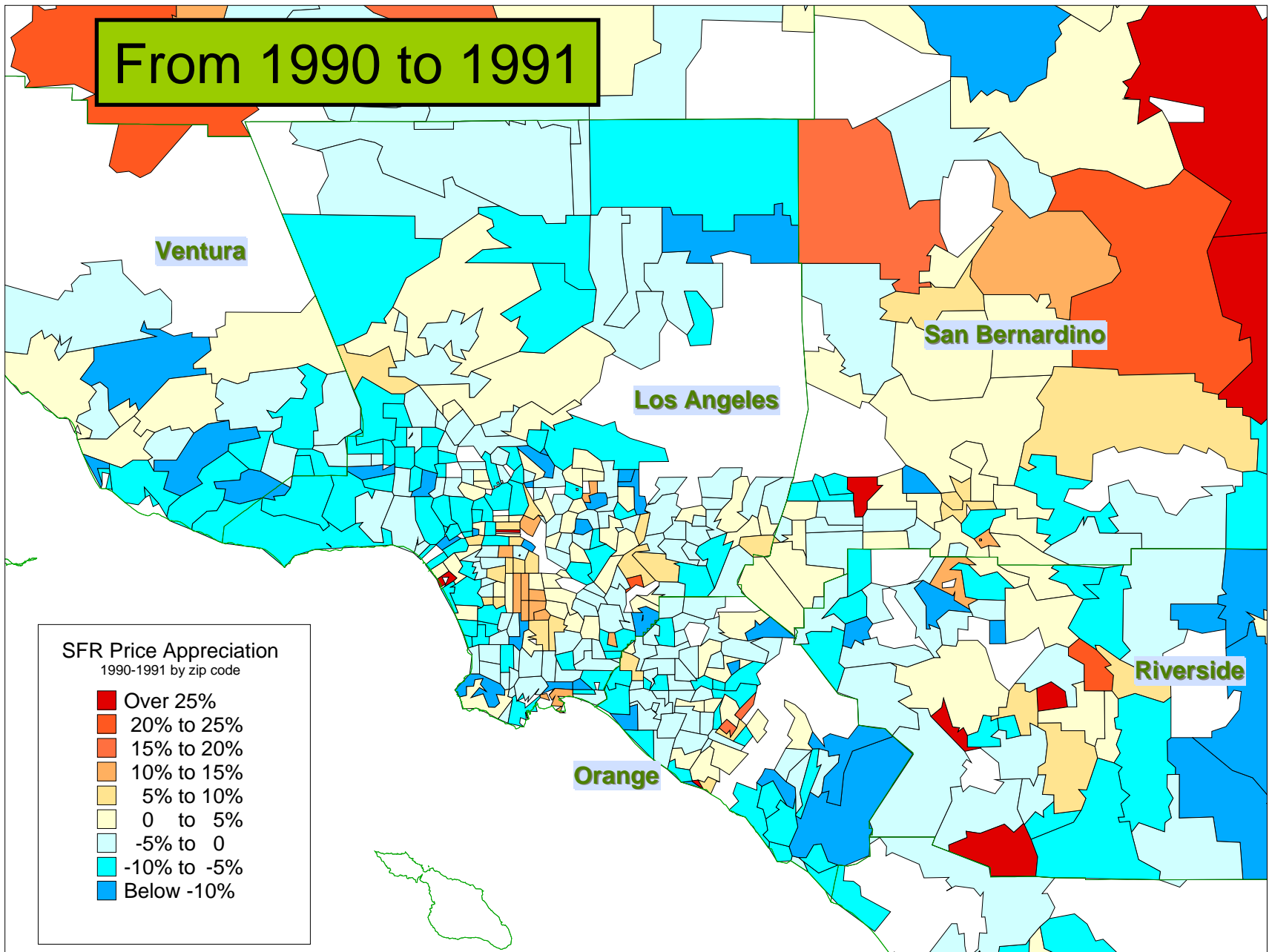
Universal bull market 1988-1989
Watch for when this happens again!

From 1989 to 1990

Surprise! The market suddenly dried up in 1990. Watch for when this happens again!



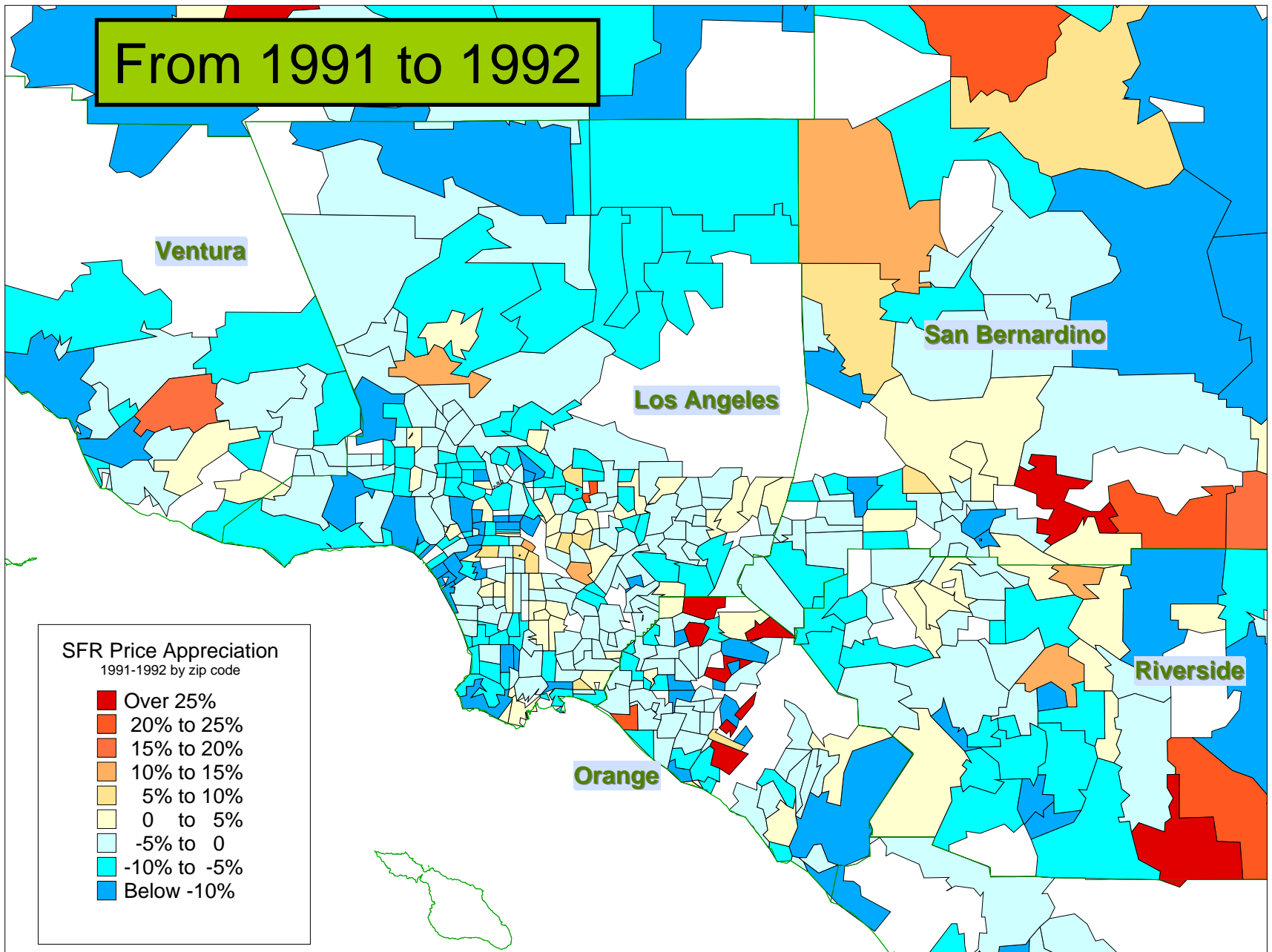
From 1990 to 1991



SFR Price Appreciation
1990-1991 by zip code

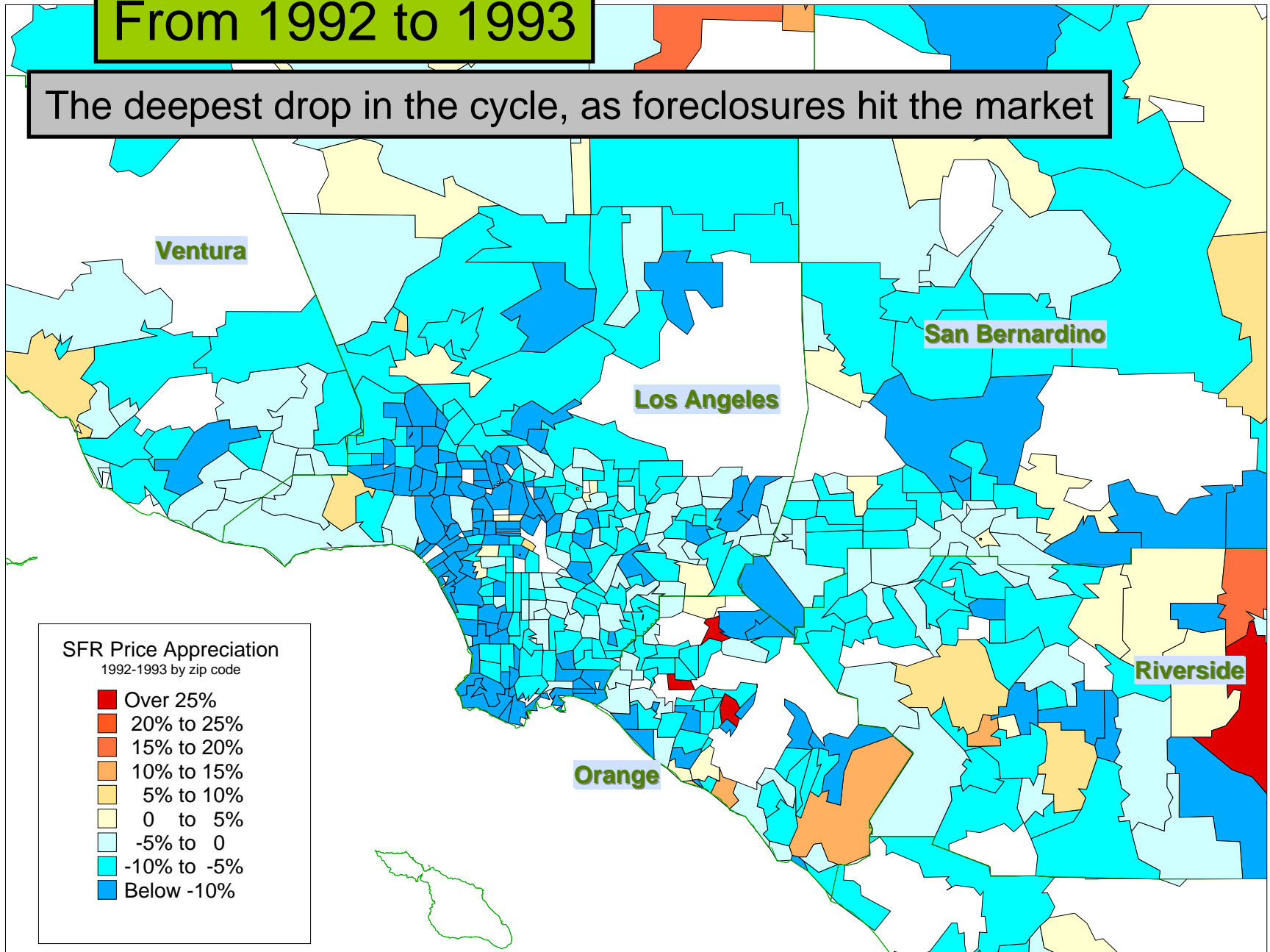
- Over 25%
- 20% to 25%
- 15% to 20%
- 10% to 15%
- 5% to 10%
- 0 to 5%
- 5% to 0
- 10% to -5%
- Below -10%

From 1991 to 1992

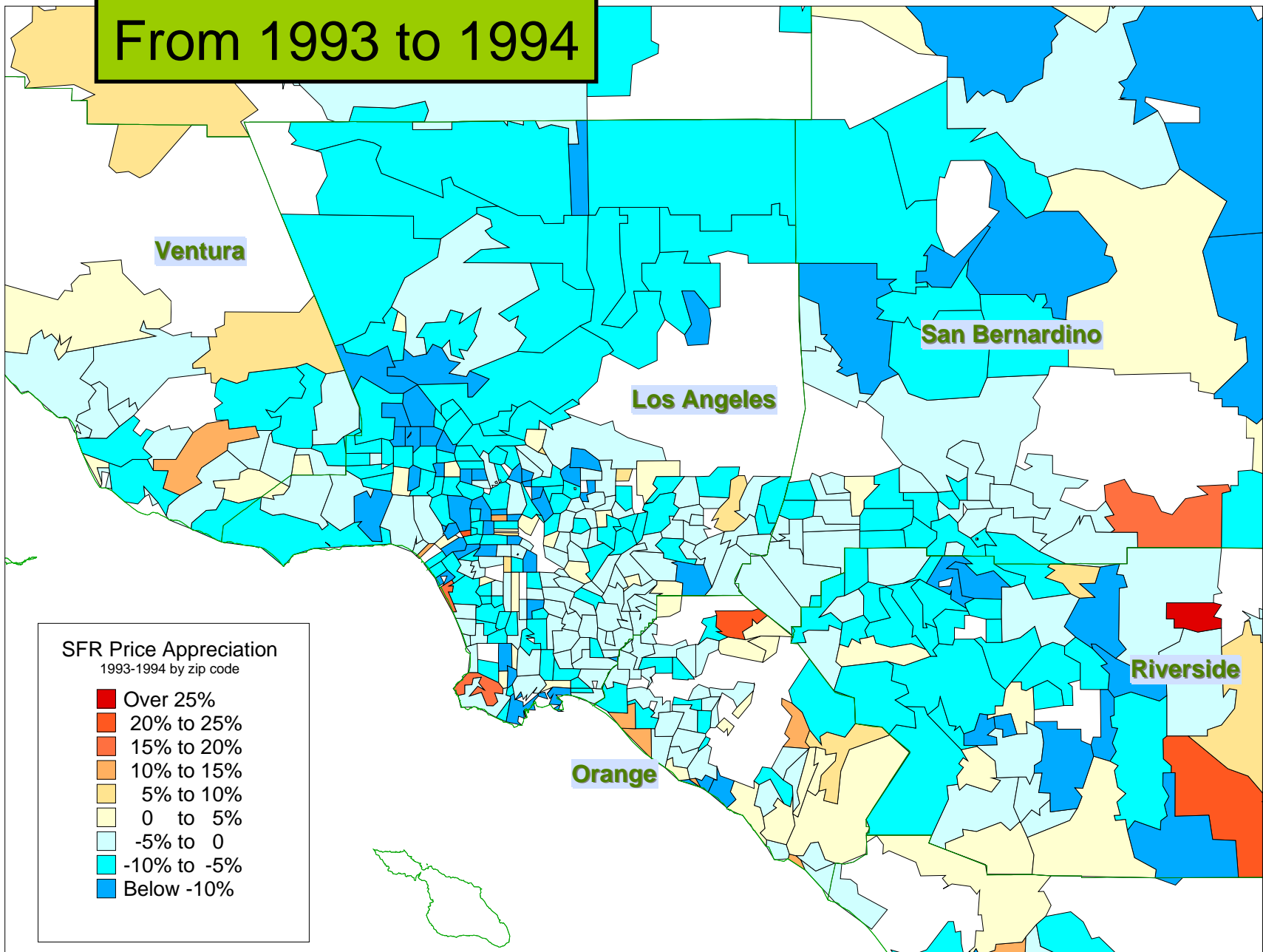


From 1992 to 1993

The deepest drop in the cycle, as foreclosures hit the market



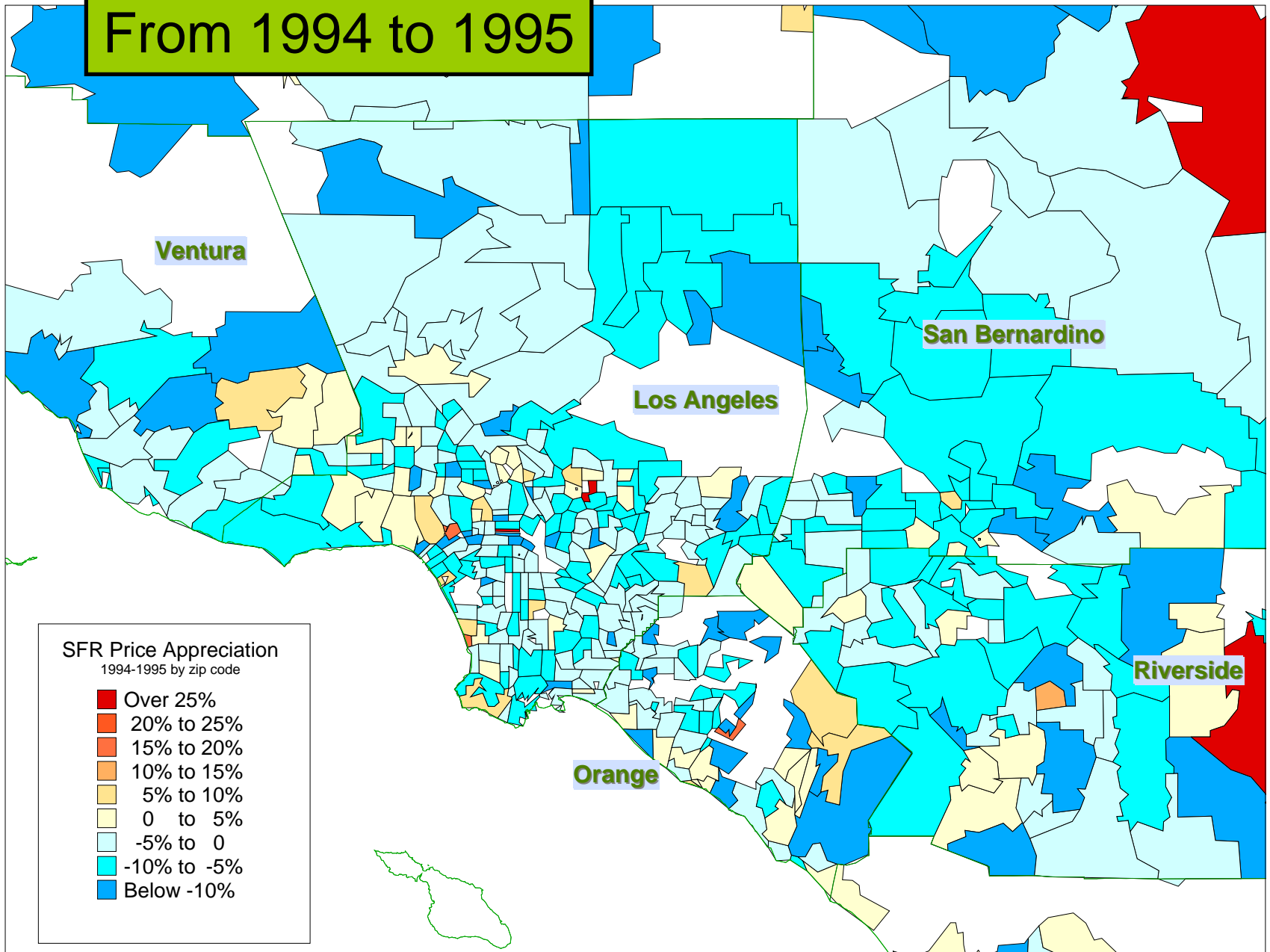
From 1993 to 1994



SFR Price Appreciation 1993-1994 by zip code

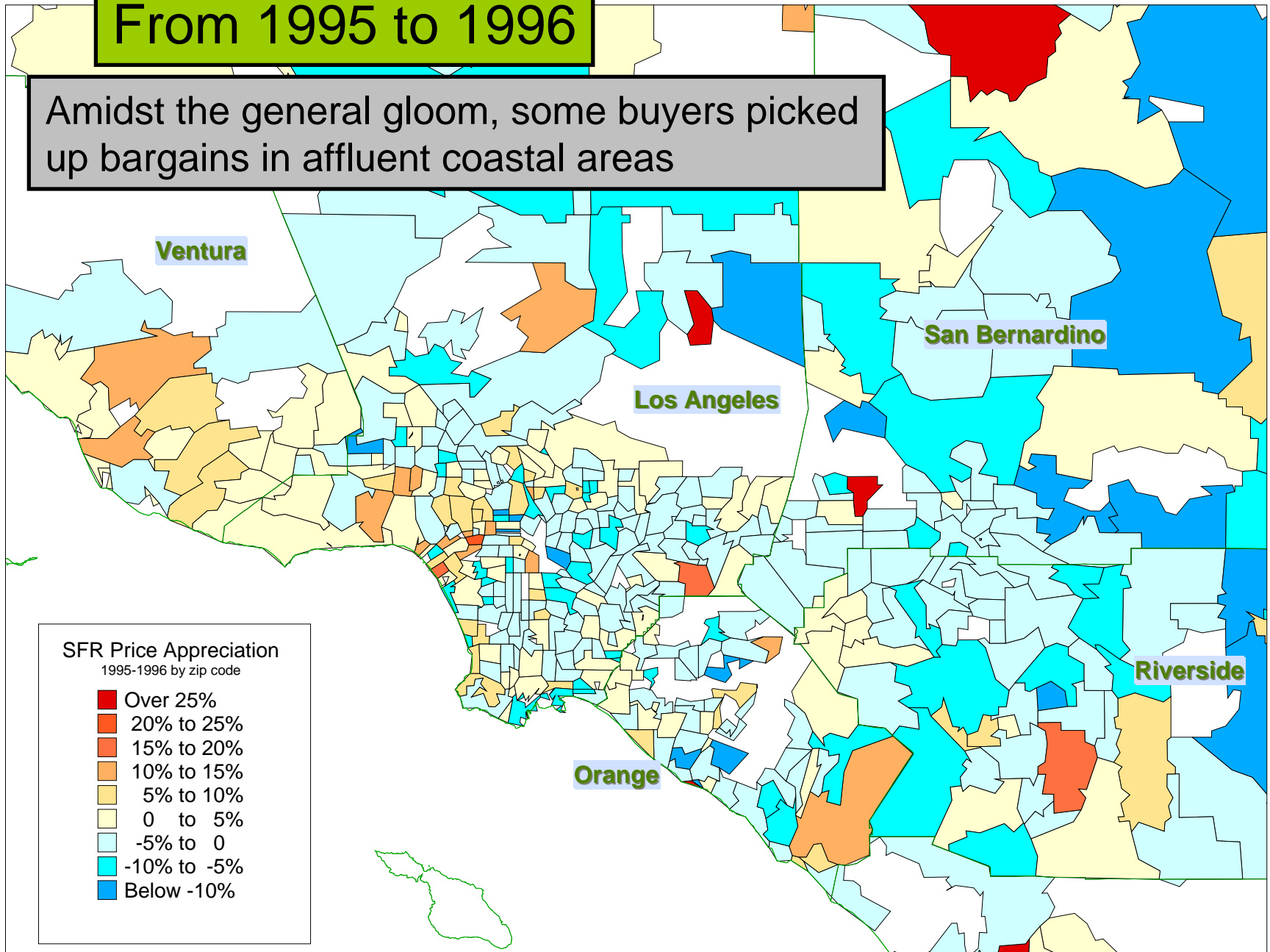
- Over 25%
- 20% to 25%
- 15% to 20%
- 10% to 15%
- 5% to 10%
- 0 to 5%
- 5% to 0
- 10% to -5%
- Below -10%

From 1994 to 1995

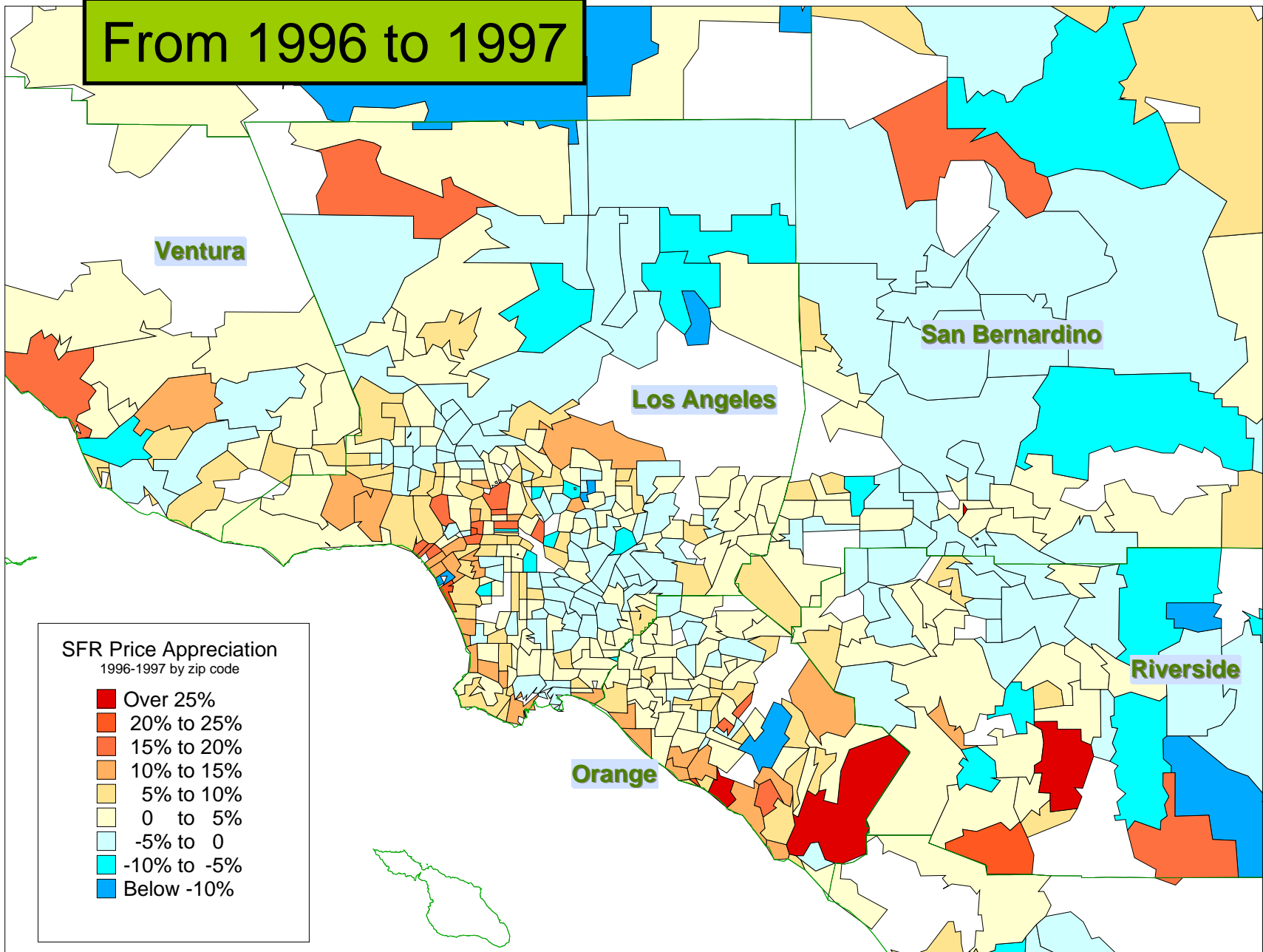


From 1995 to 1996

Amidst the general gloom, some buyers picked up bargains in affluent coastal areas



From 1996 to 1997

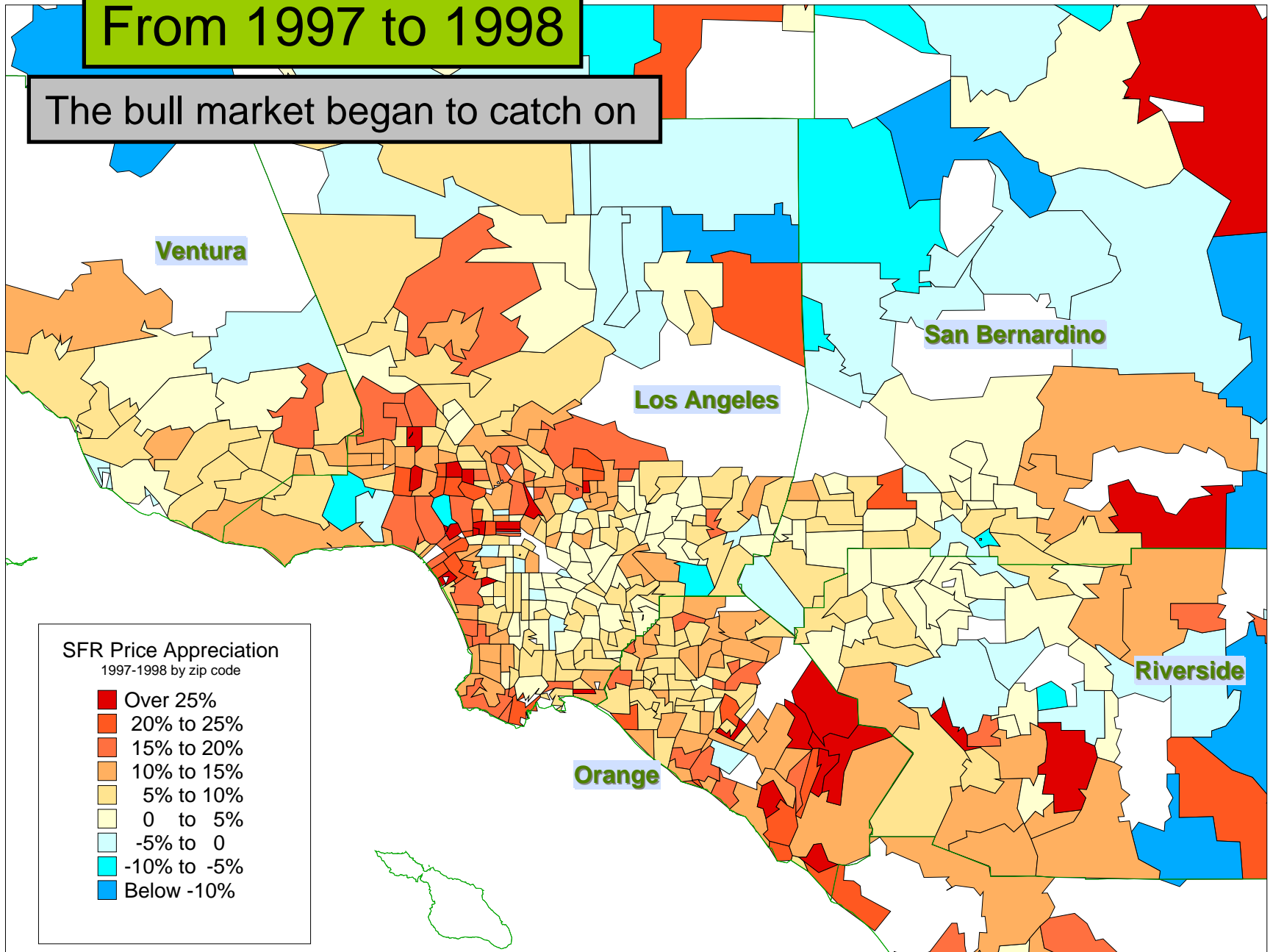


SFR Price Appreciation
1996-1997 by zip code

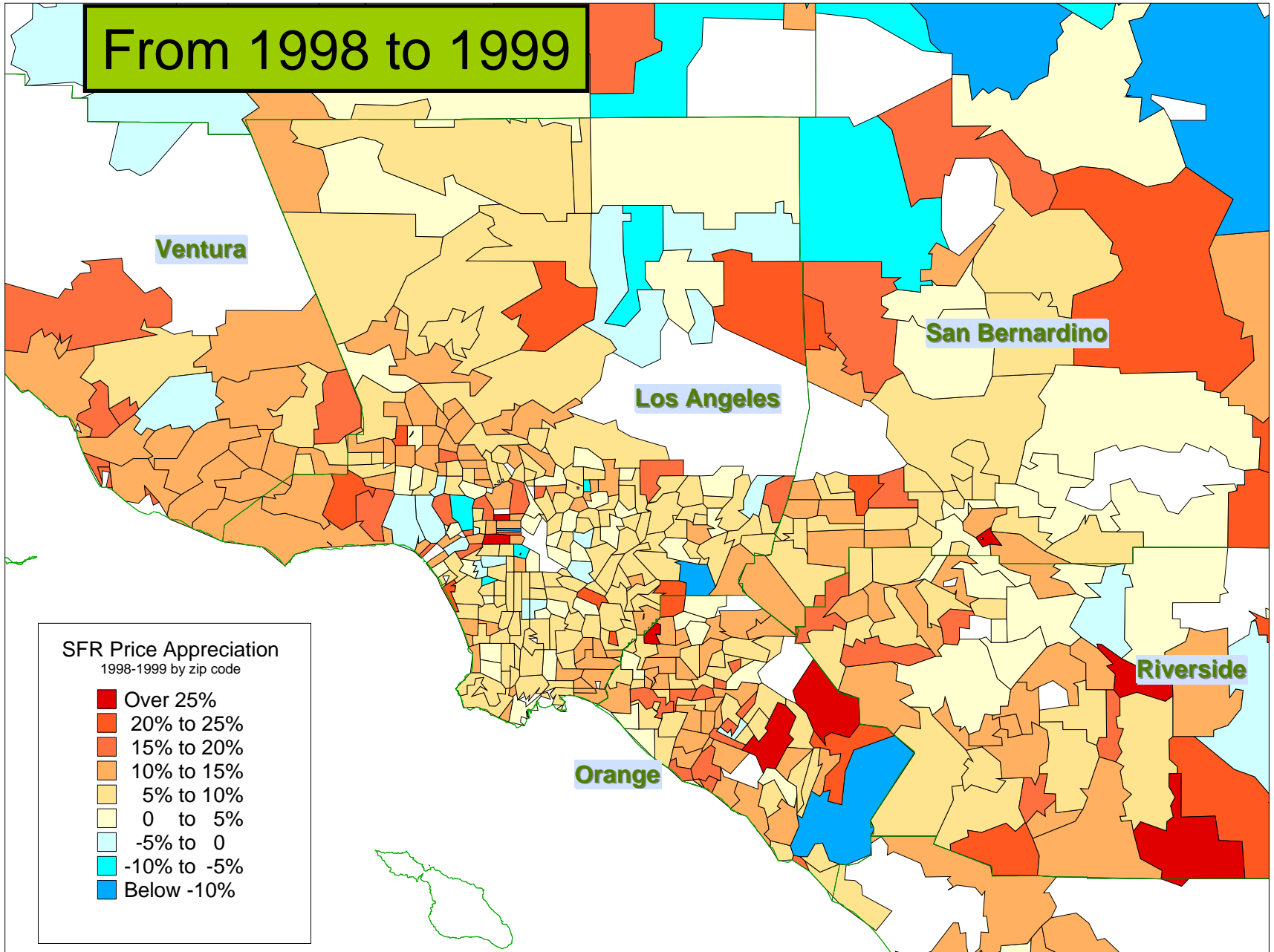
- Over 25%
- 20% to 25%
- 15% to 20%
- 10% to 15%
- 5% to 10%
- 0 to 5%
- 5% to 0
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- Below -10%

From 1997 to 1998

The bull market began to catch on



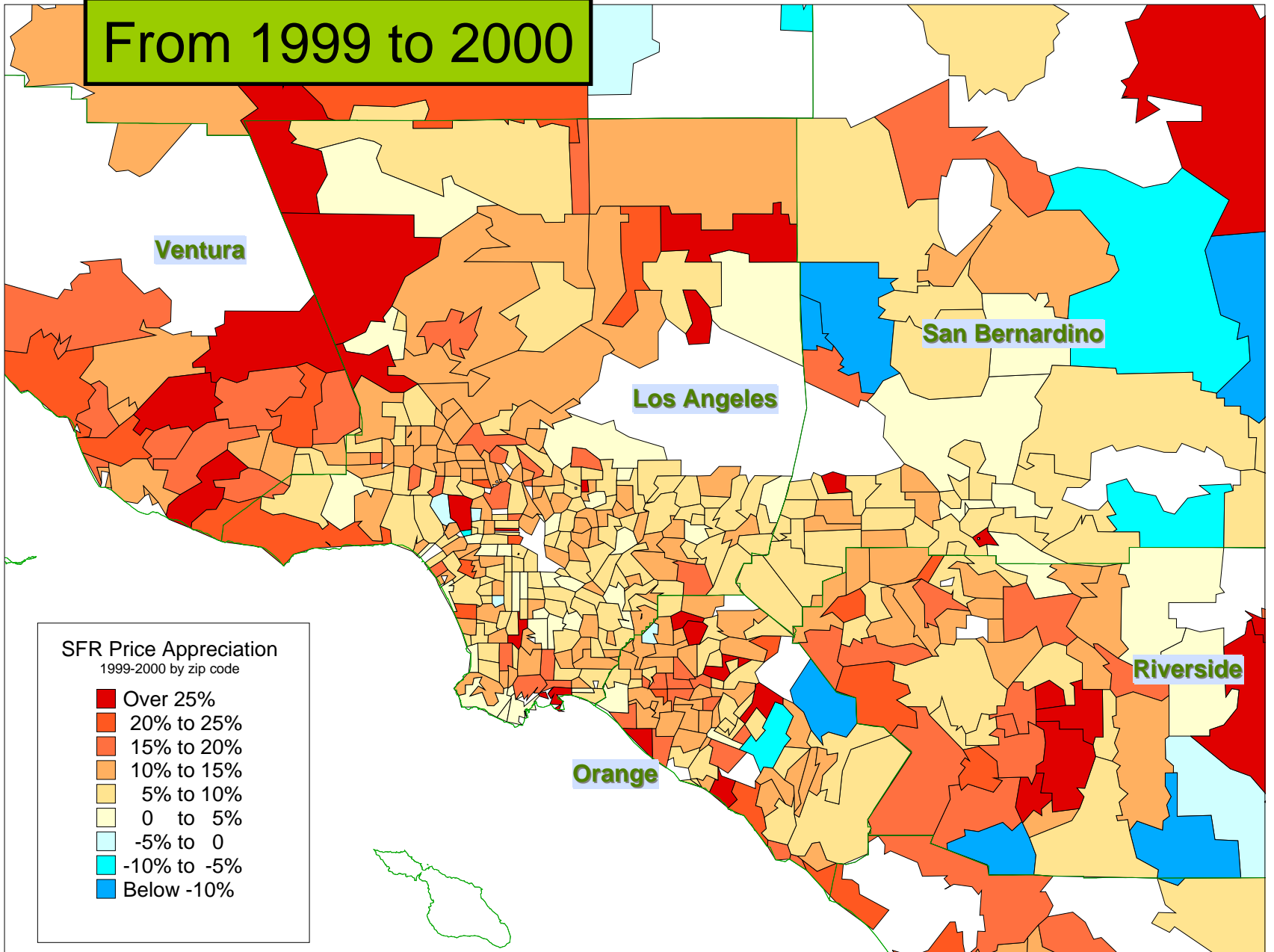
From 1998 to 1999



SFR Price Appreciation
1998-1999 by zip code

- Over 25%
- 20% to 25%
- 15% to 20%
- 10% to 15%
- 5% to 10%
- 0 to 5%
- 5% to 0
- 10% to -5%
- Below -10%

From 1999 to 2000



Ventura

San Bernardino

Los Angeles

Riverside

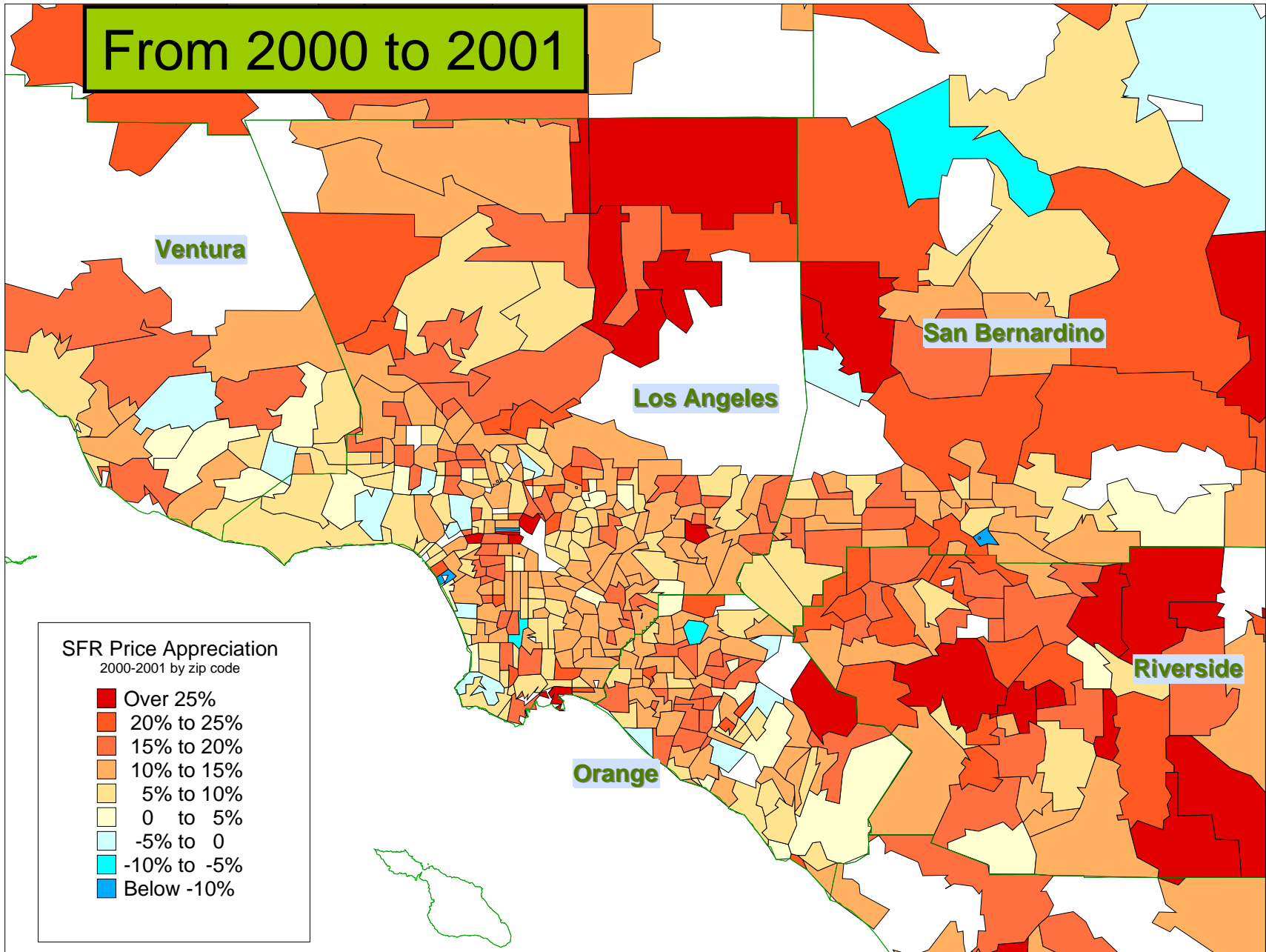
Orange

SFR Price Appreciation

1999-2000 by zip code

- Over 25%
- 20% to 25%
- 15% to 20%
- 10% to 15%
- 5% to 10%
- 0 to 5%
- 5% to 0
- 10% to -5%
- Below -10%

From 2000 to 2001



Ventura

San Bernardino

Los Angeles

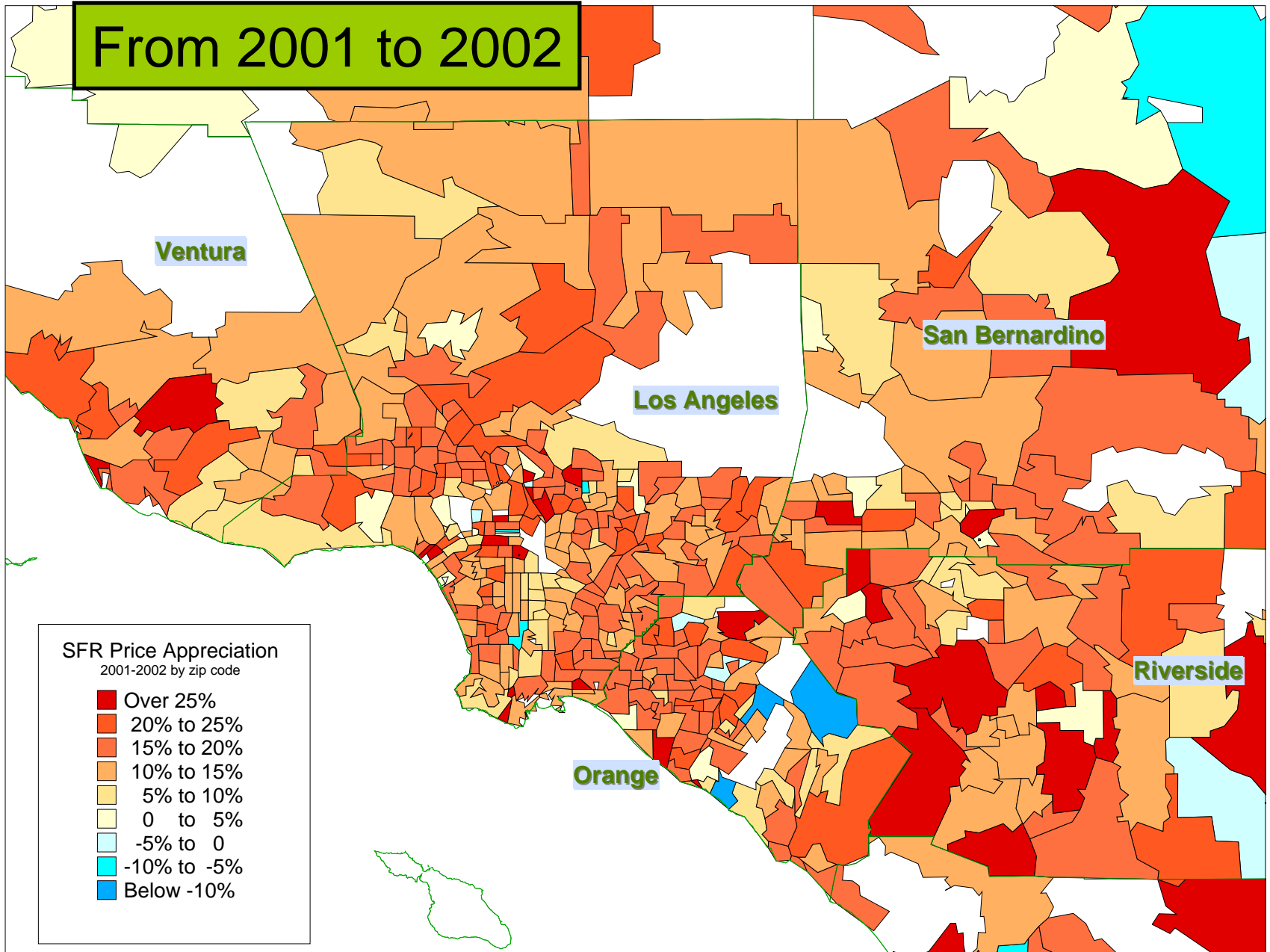
Riverside

Orange

SFR Price Appreciation 2000-2001 by zip code

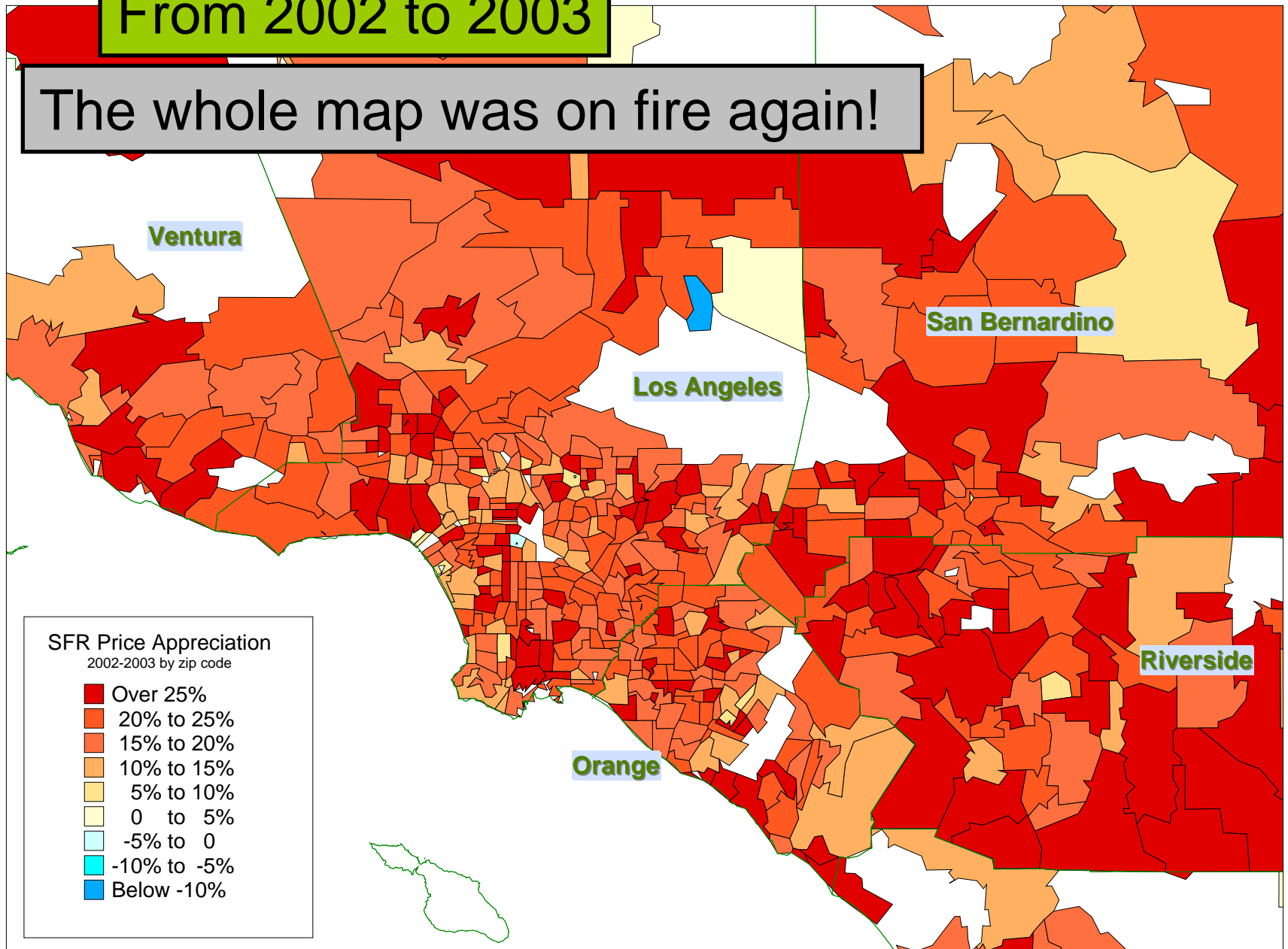
- Over 25%
- 20% to 25%
- 15% to 20%
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- 5% to 10%
- 0 to 5%
- 5% to 0
- 10% to -5%
- Below -10%

From 2001 to 2002



From 2002 to 2003

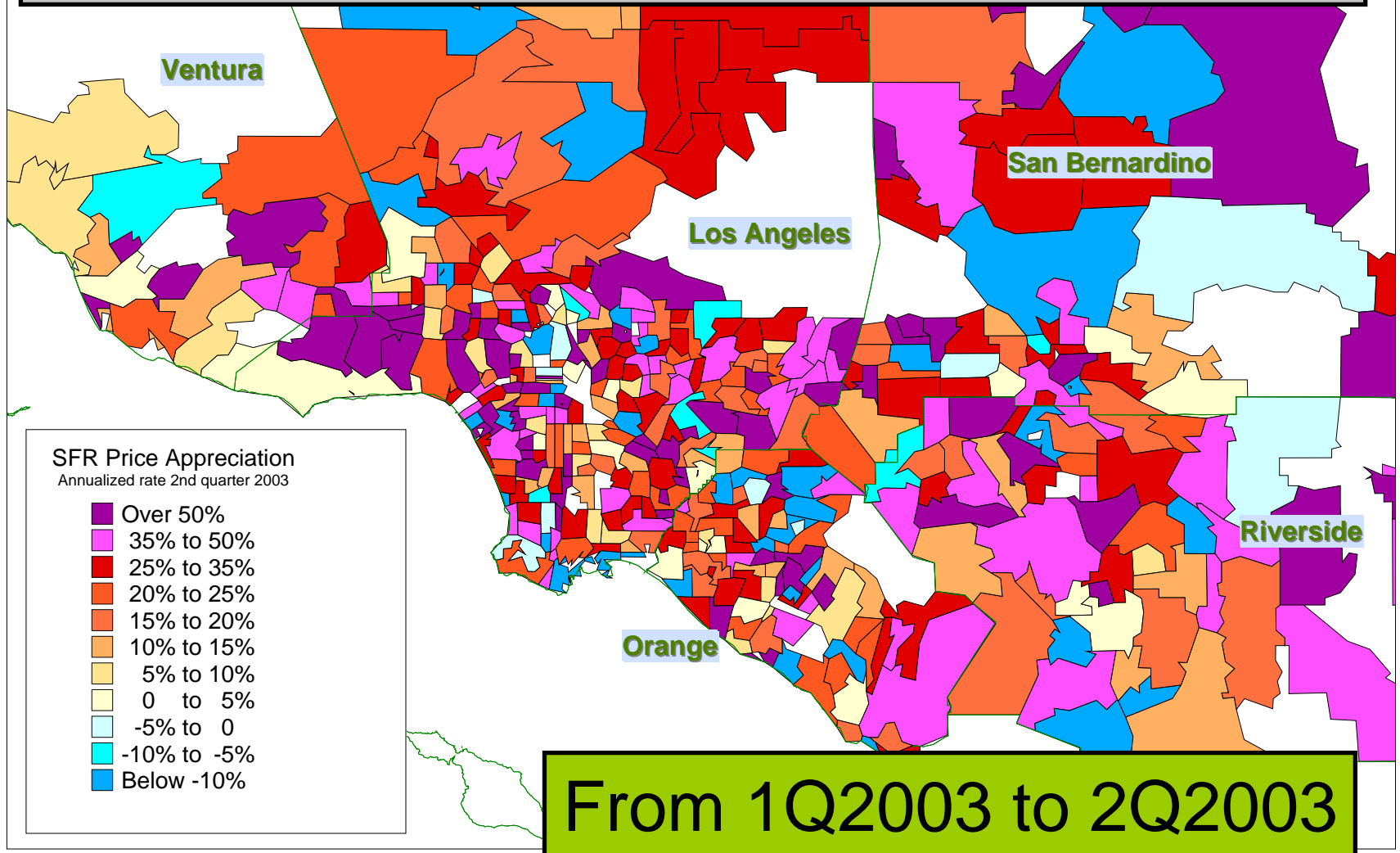
The whole map was on fire again!



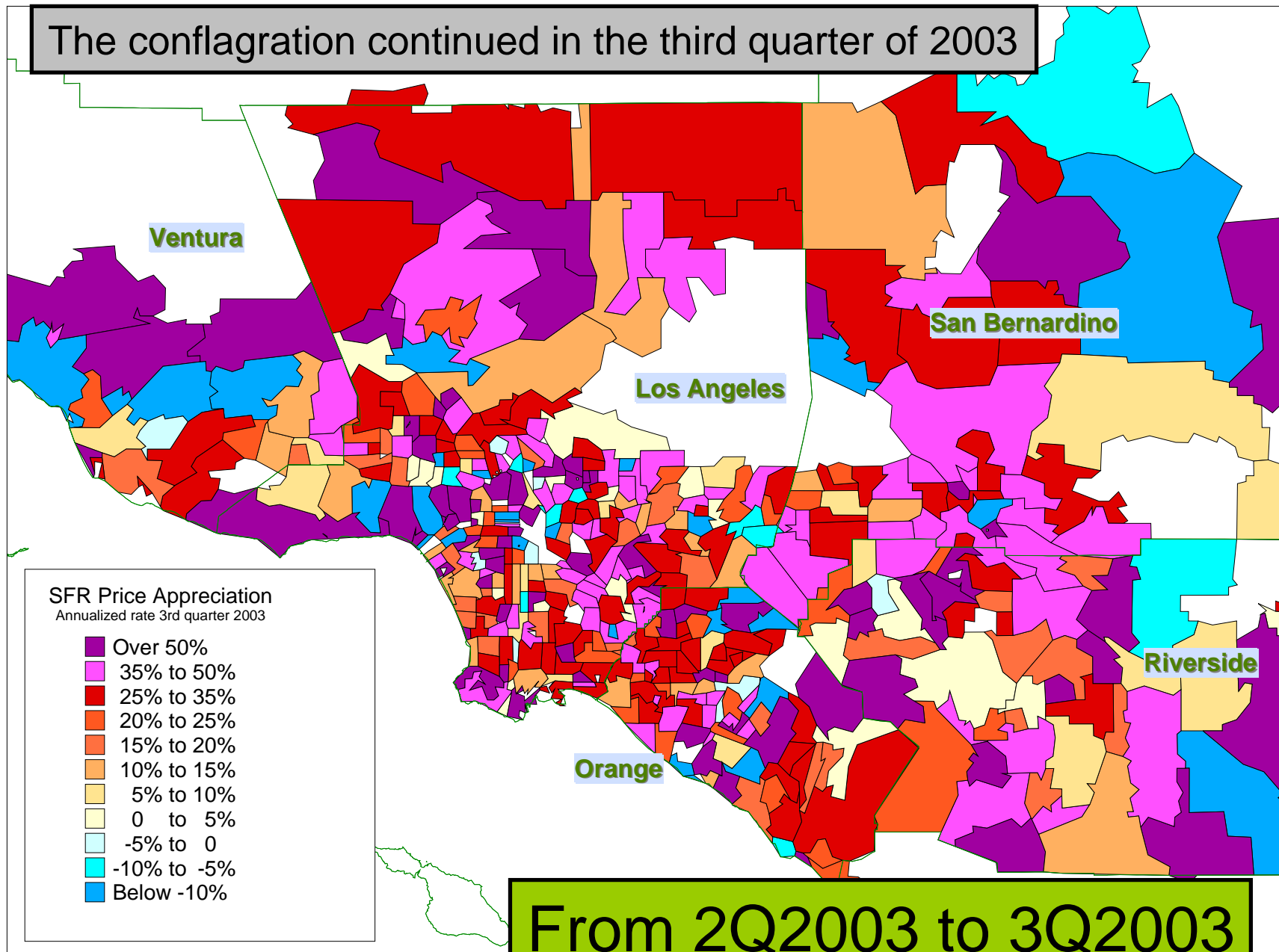
The last 18 months in slow motion:

1. The following maps display the rate of change each quarter, *converted to an annualized rate*.
2. Because the number of sales in a quarter is smaller than in a year, the quarterly zip code maps will be much more irregular than the yearly maps.
3. The market rose at an incredible and unsustainable pace in the first half of 2004, often over 5% per month, requiring the use of new purple colors on the map. But then the market suddenly turned in the summer of 2004 and flattened out.

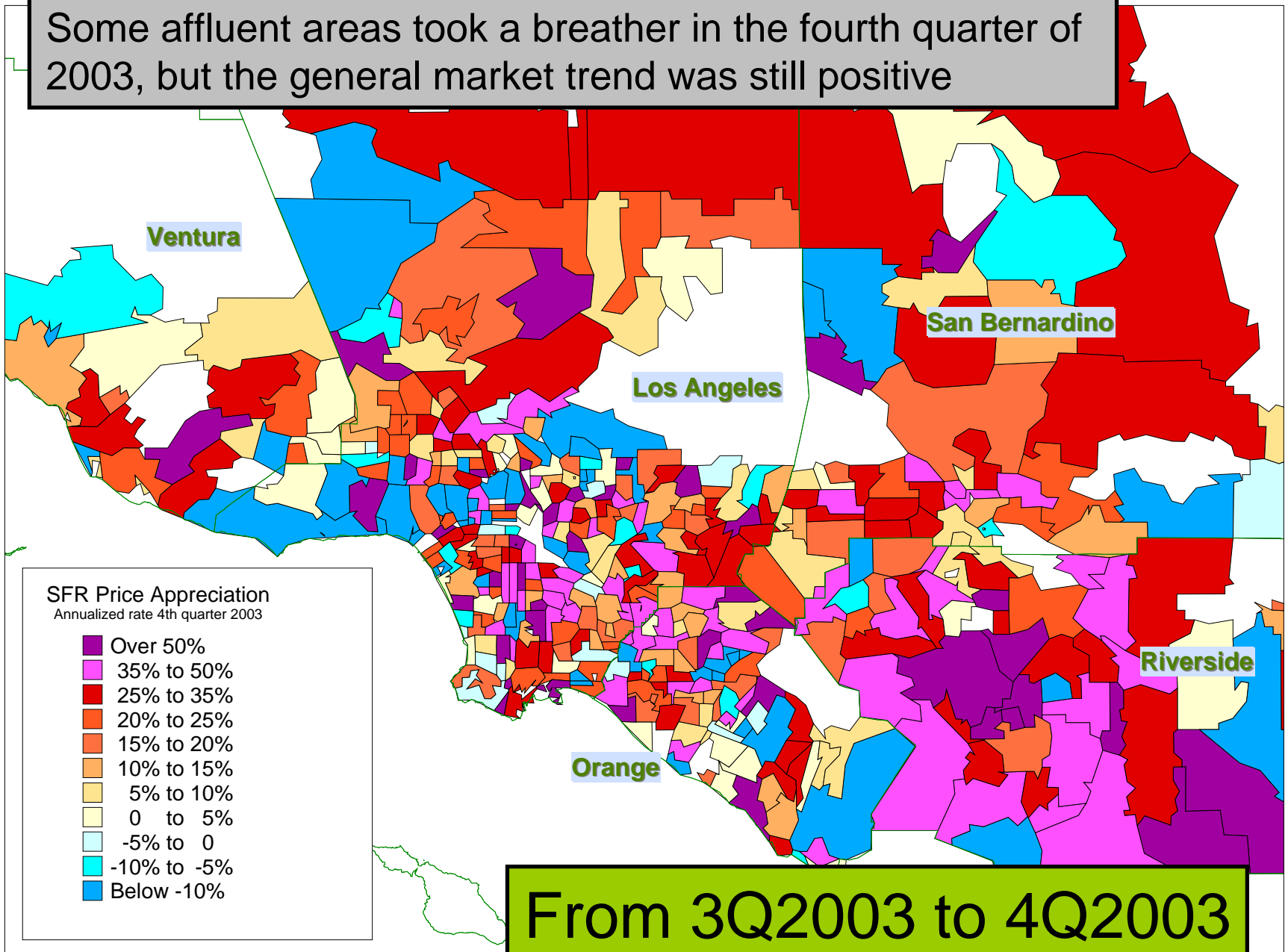
In the second quarter of 2003 the general market was sizzling. The irregular granularity of the color map is due to small sales counts in single zip codes over only three months instead of a year.



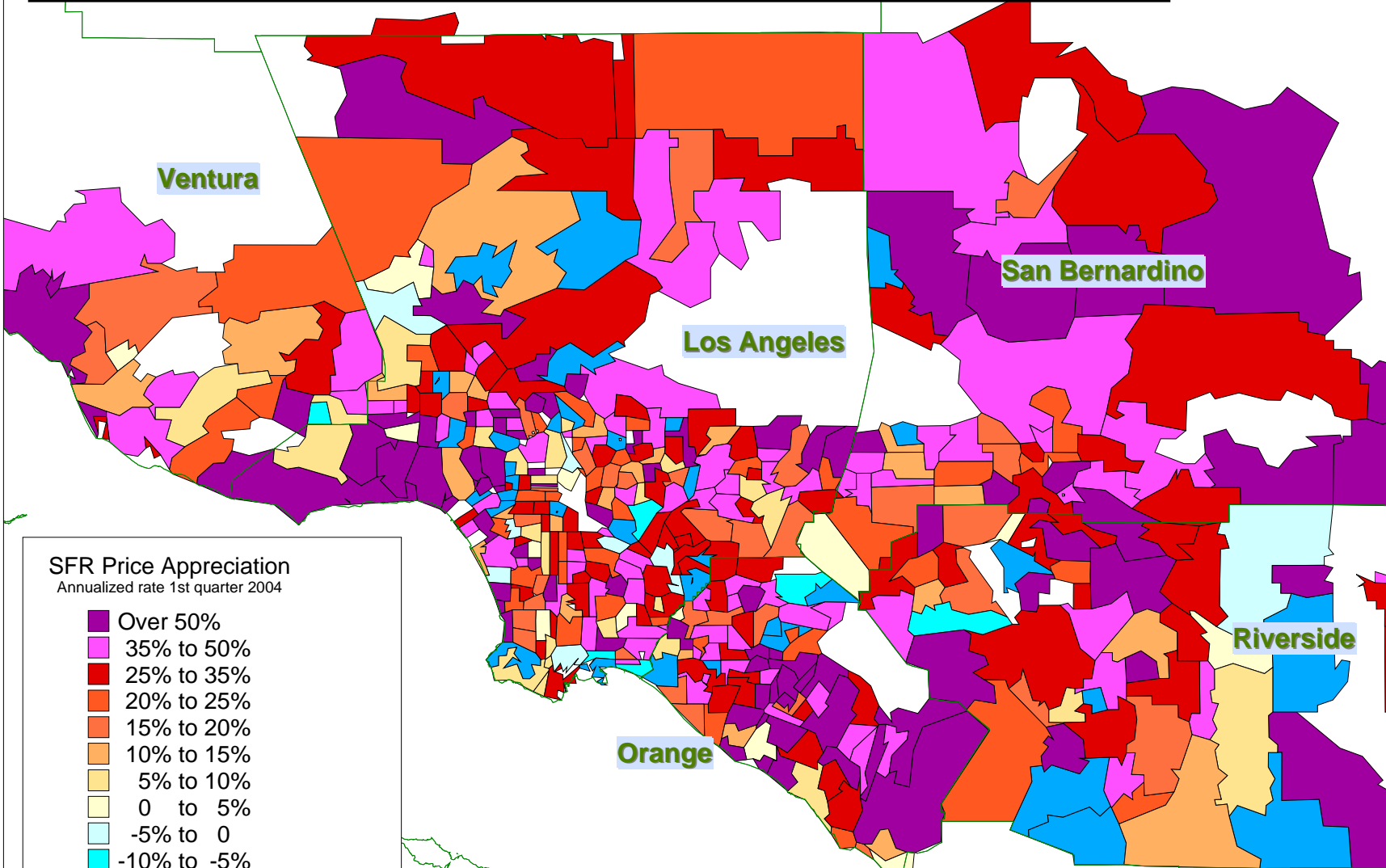
The conflagration continued in the third quarter of 2003



Some affluent areas took a breather in the fourth quarter of 2003, but the general market trend was still positive



In the first quarter of 2004, prices again rocketed upward

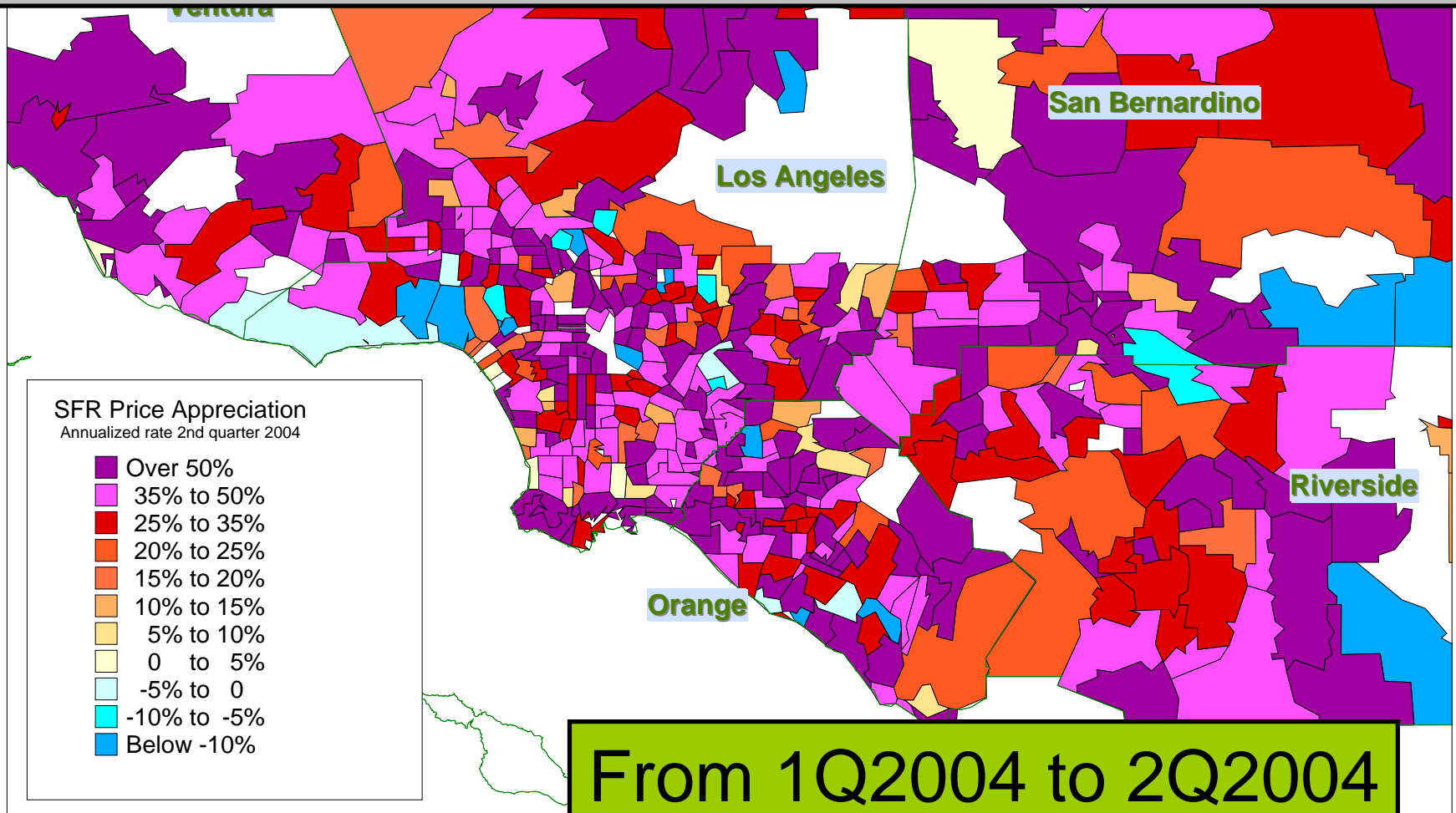


SFR Price Appreciation
Annualized rate 1st quarter 2004

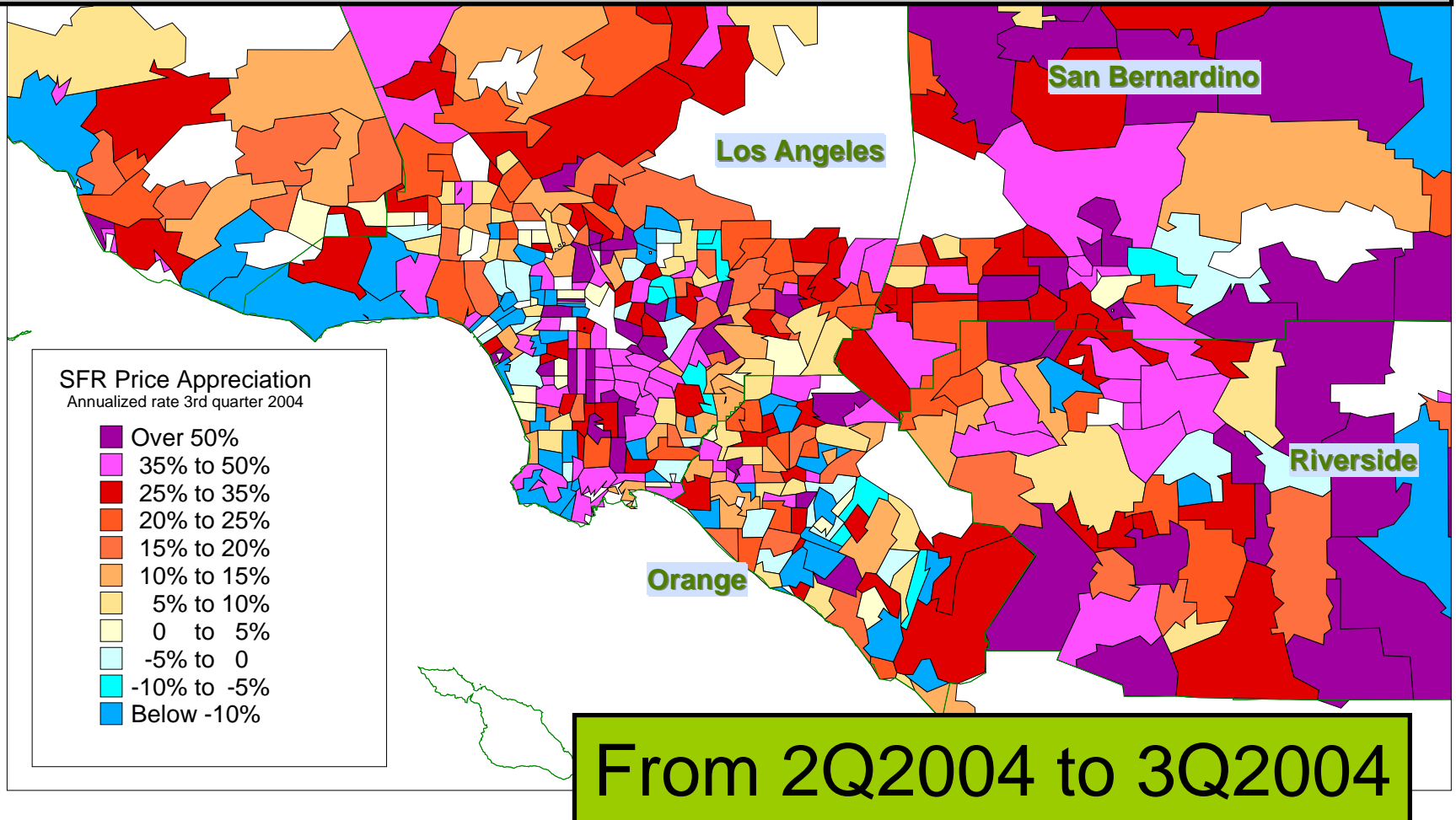
- Over 50%
- 35% to 50%
- 25% to 35%
- 20% to 25%
- 15% to 20%
- 10% to 15%
- 5% to 10%
- 0 to 5%
- 5% to 0
- 10% to -5%
- Below -10%

From 4Q2003 to 1Q2004

The second quarter of 2004 was the very hottest part of the boom. Prices rose at 5% a month or faster! Properties often had multiple offers their first day of listing, and often sold above their asking prices. This intensity, with many areas rising at over 50% annualized, “blew everyone away” while it lasted, but was unsustainable on a long-term basis.



Surprise! In the summer (third quarter) of 2004, the market suddenly lost steam. Inventory offered for sale was much greater, and price growth slowed down or even reversed. The market turn was most pronounced in the affluent coastal areas, as the affordable inland regions continued to do well. Compare this with the 1990 map.

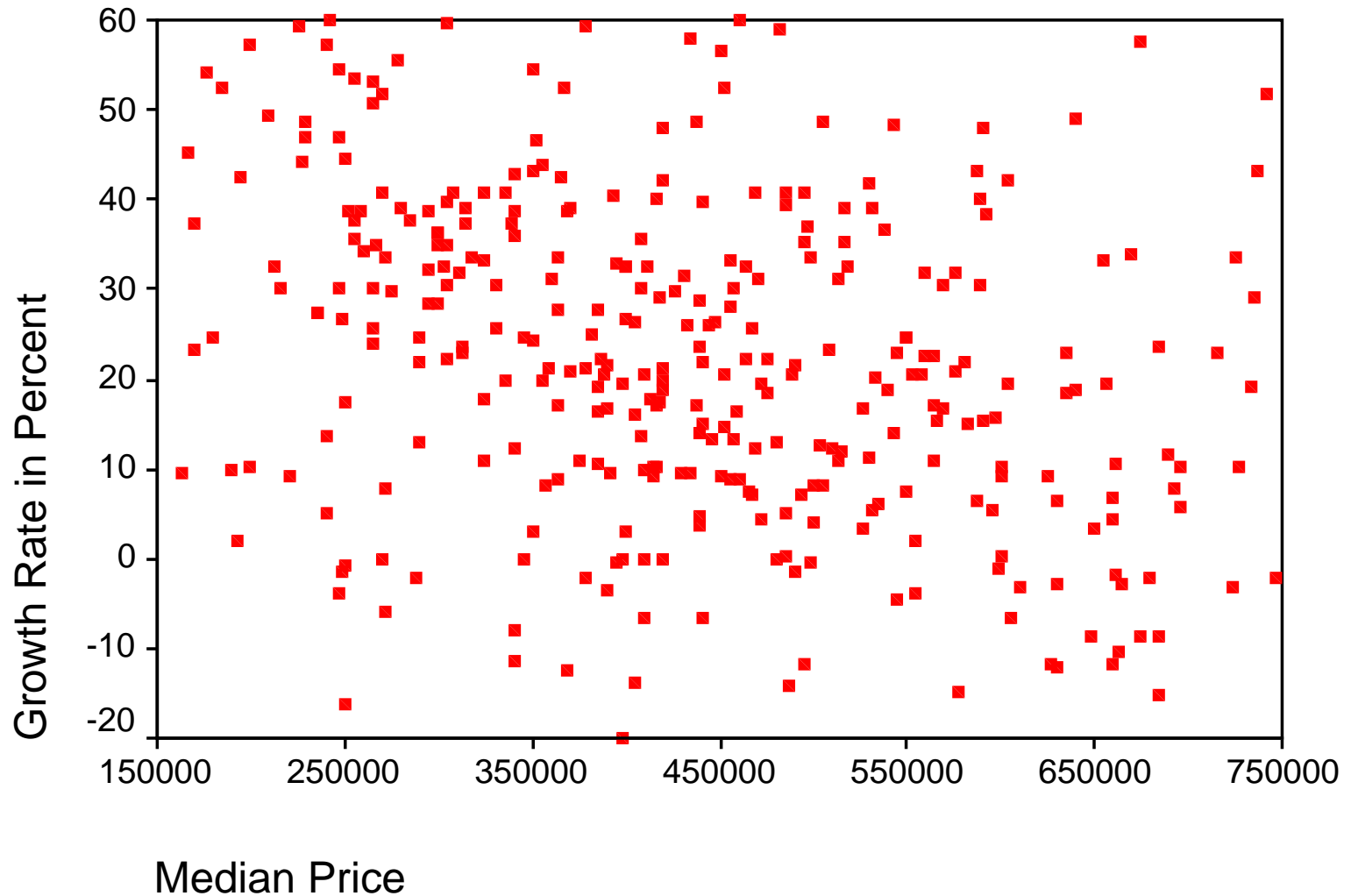


The slowdown started at the high end

1. Generally, the high end *leads* the market. High-end desirable locations usually are where a bull market starts, as people pick up bargains. Less expensive areas catch on later.
2. In the last map, the cooling began in the affluent coastal areas. Affordable inland areas are still hot.
3. The graph on the next slide shows how less expensive zips tended to be “hotter” in the third quarter of 2004 than the costlier areas. The group of points slopes “down” on the scatter plot.

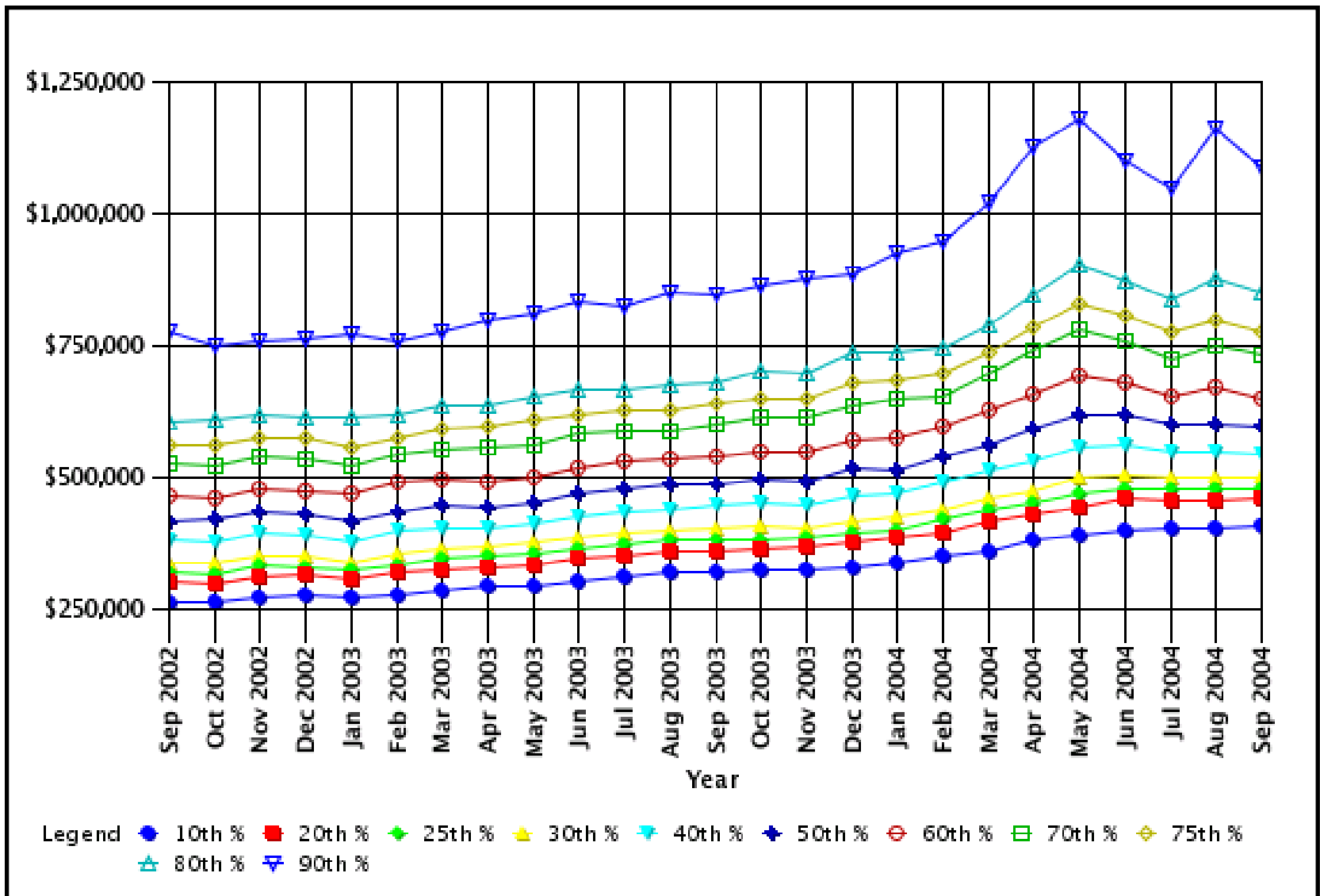
Annualized Growth Rate of SFR Prices

For Zip Codes, 3rd Quarter 2004



The slowdown started at the high end

1. A look at the *percentiles* of SFR prices in Orange County shows that the higher tiers of the market lost steam during the summer of 2004, while the lower, more “affordable” tiers remained firm in price. This is shown on the next slide.
2. The summer “soft spot” is small in impact in the middle levels of the market but becomes more and more pronounced going up the scale.

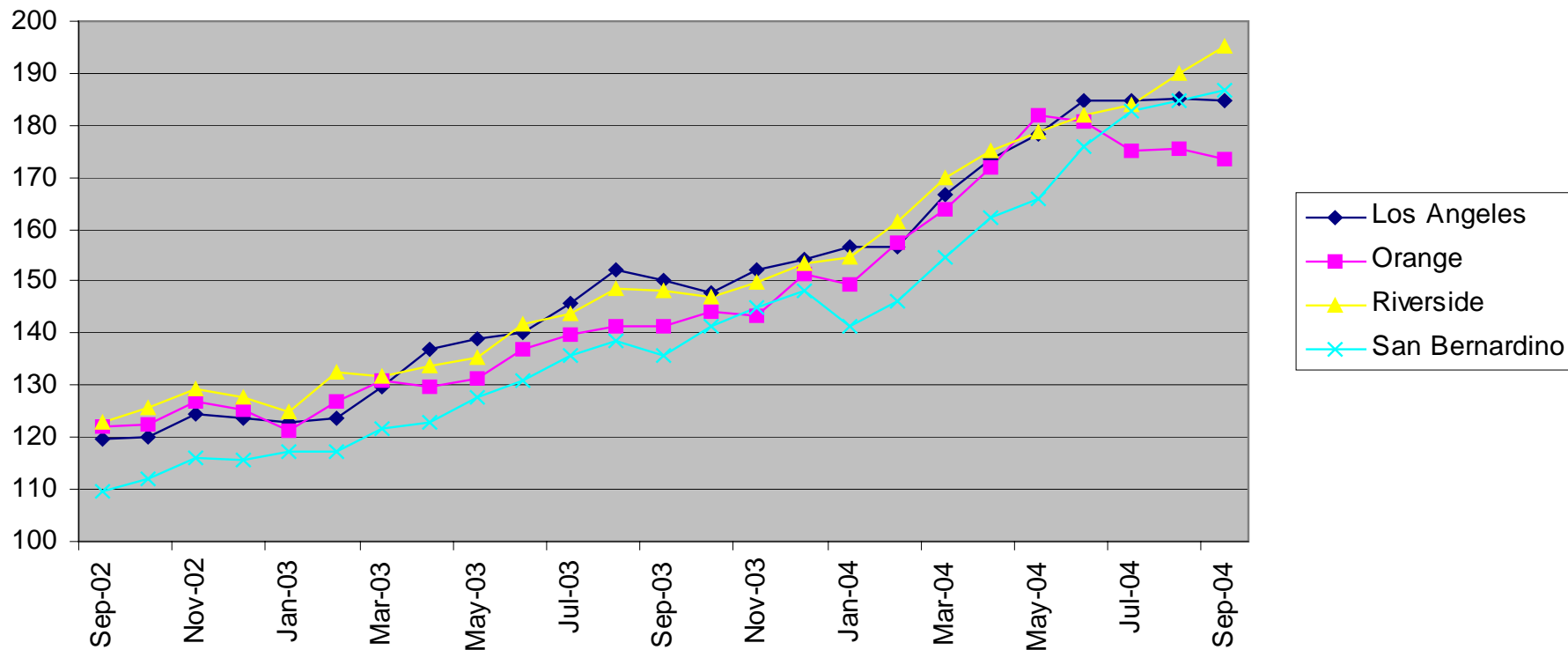


Source: Real Estate Trends beta version, First American Real Estate Solutions, "Percentile" module.

The business cycle turns

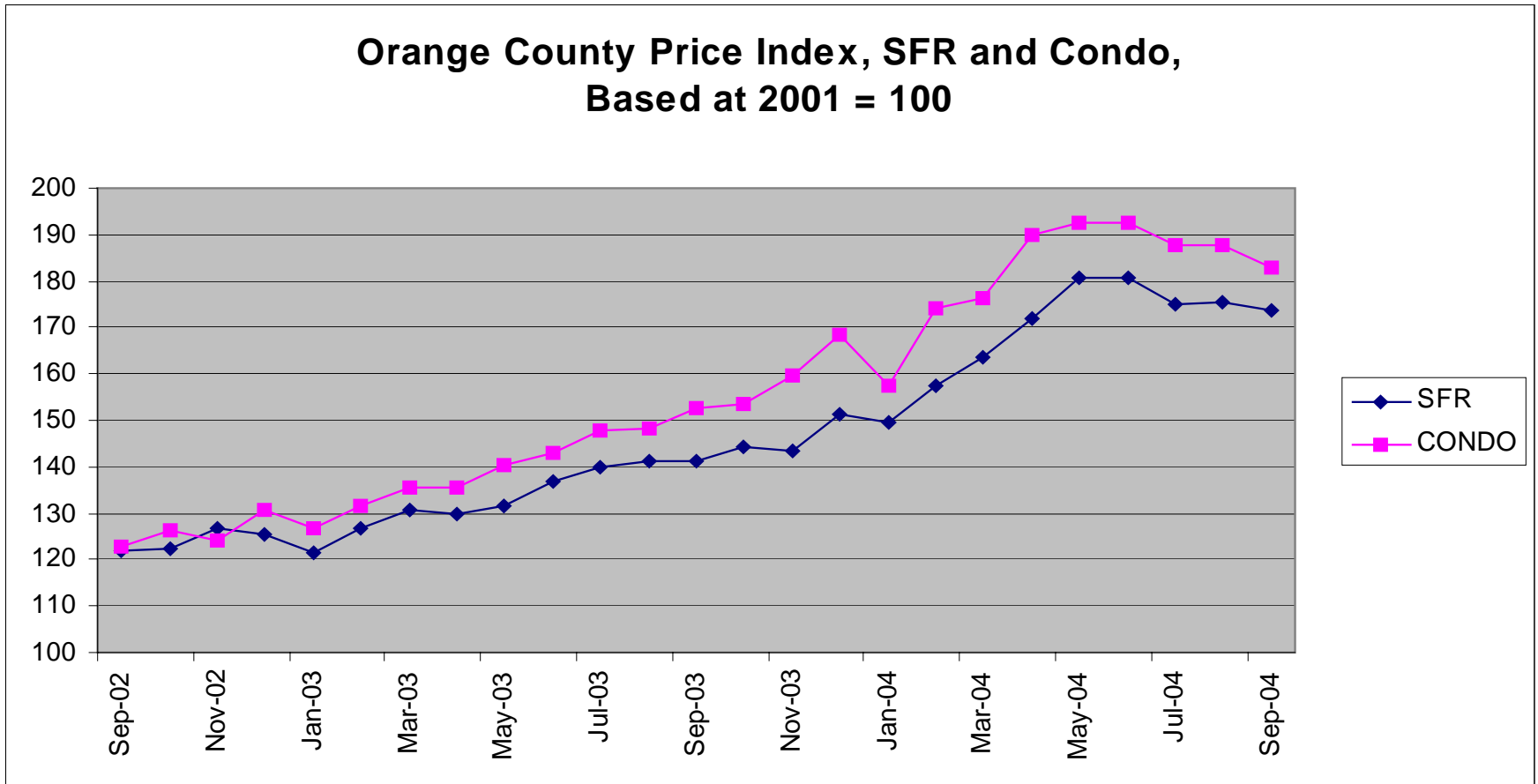
- Next, we'll compare the *price index* for four Southern California counties. The SFR price level in each county is set at 100 for the base year of 2001.
- Orange County, the most affluent of the four, led the group for much of the two-year period graphed on the next slide.
- San Bernardino County, the least expensive of the four, lagged behind at first, but then caught up as prices of its “affordable” housing rose explosively while the market in Orange and Los Angeles Counties slowed down.
- The “affordable” Riverside County market also surged in the third quarter of 2004 while the Orange County market weakened.

SFR Price Index by County, Based at 2001 = 100



Source: *Real Estate Trends* beta version, First American Real Estate Solutions, "Price Index" variable.

Within Orange County itself, the “affordable” condo market outpaced the pricey SFR market.



Source: *Real Estate Trends* beta version, First American Real Estate Solutions, “Price Index” variable.

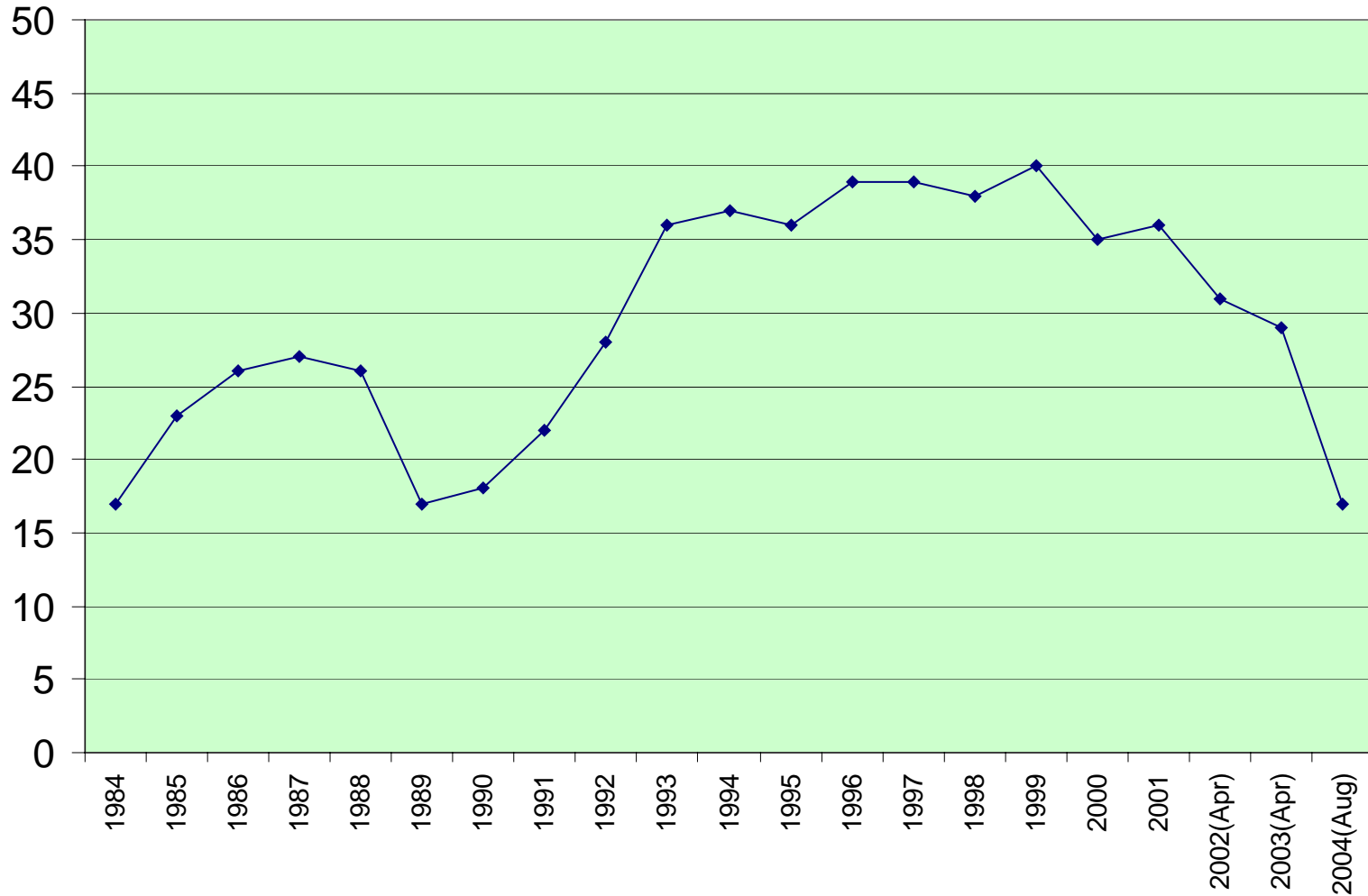
What *fueled* the boom?

- Clearly, *low mortgage rates* had a lot to do with it!
- *Inventory* offered for sale had been only one or two months' worth of sales – leading to houses receiving multiple offers their first day of listing, often selling for well over asking price – and at the height of the boom, prices went up at unsustainable rates of 5% per *month* or even faster.

What ended the boom?

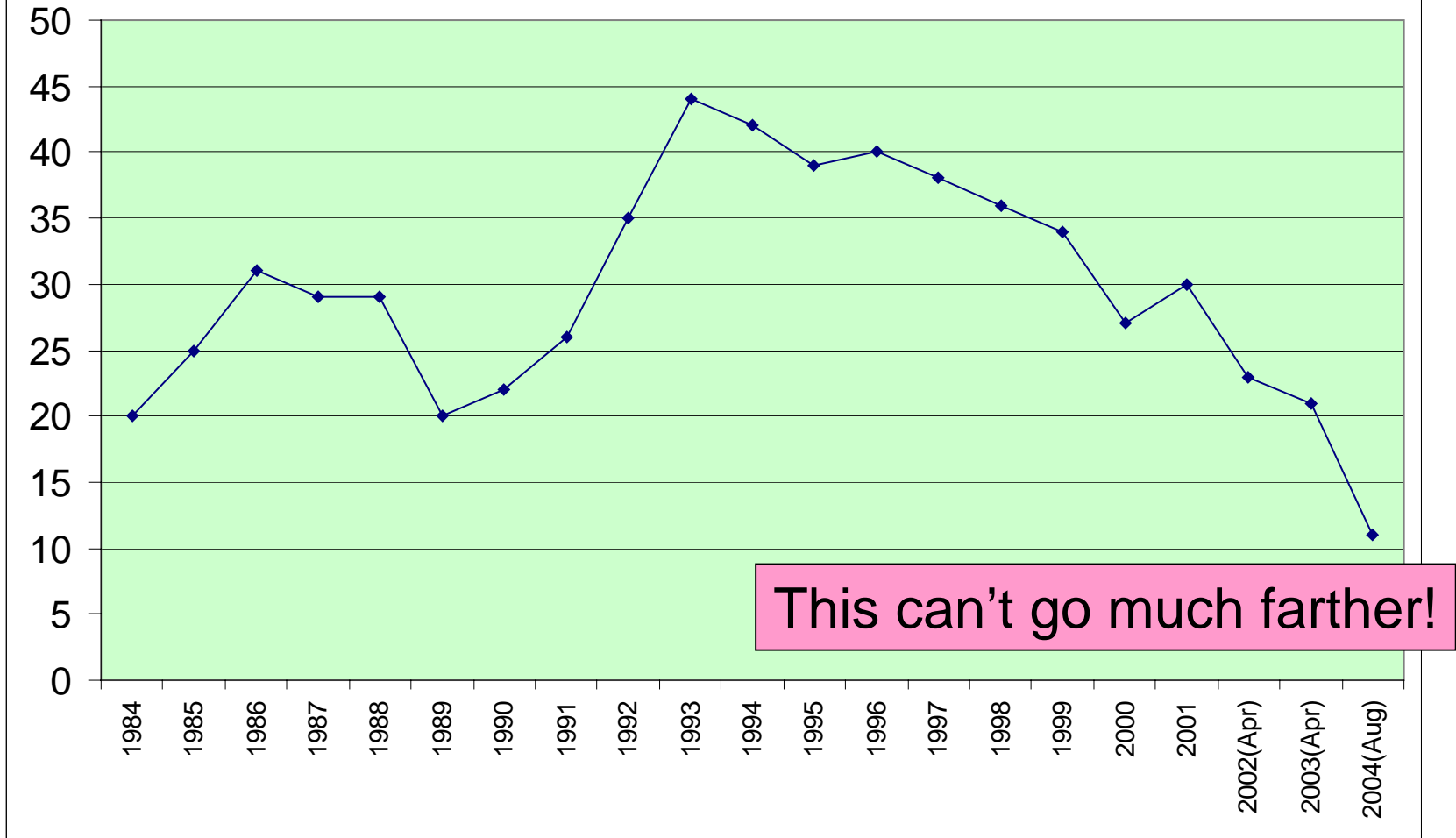
- Mortgage rates have risen only slightly since their 45-year lows in the summer of 2003 – so that wasn't it.
- ***Affordability*** was the biggest reason prices stopped rising. In Los Angeles County only 17% of the households could purchase the median-priced home. In Orange County, that figure was only 11%. Affordability this low is characteristic of a market top. Although over half of buyers used adjustable mortgages and other creative financing, this did not solve the affordability problem completely.
- ***Inventory*** levels increased in the summer of 2004, often to historically normal levels of six months' worth of sales. In this "normal" market, buyers could take their time instead of making a "panic purchase." Sellers had to price their properties more carefully and often had to wait longer for an offer – which frequently came under the asking price.

CAR Affordability Index, Los Angeles County



Source: California Association of Realtors®

CAR Affordability Index, Orange County



Source: California Association of Realtors®

What has happened? What will happen?

- What has happened is a return to normal market conditions after a very long and powerful bull market. The traditional interaction of buyer and seller will go on.
- The near future will not bring a market crash.
- The near future will not bring a new buying frenzy.
- The near future will be much less exciting – a simple return to normalcy. Sellers will have to judiciously price their properties instead of expecting an offer beyond their wildest dreams on the first day of listing. Buyers will look at one residence after another until they choose one to bid on, just as has gone on for many years. Buyers and sellers will negotiate prices just as always. *Life will go on!*

What is my outlook for 2005?

- Mortgage rates will probably be higher than now, but not so high as to seriously damage the market (that would need 30-year fixed rates of 7.5% or 8%).
- In *affluent* areas prices will be the same as they are now, or slightly lower.
- In *affordable* areas prices will be higher than they are now, as the rising market has not yet reached its peak there.
- ***Prices will not go up – or down – dramatically from 2004 levels.***
 - There isn't "affordability room" for another 20% or 30% price increase, especially with mortgage rates expected to rise.
 - With rates still historically low, and a healthy economy, there is no reason to expect a dramatic price drop in 2005.
 - That is, 2005 will likely be a "sideways" year, with market rises and market dips, but no huge move up or down.

What is my advice for 2005?

- For *sellers* – it's a great time to sell, at good prices. But make sure you have planned where you will be moving to!
- For *buyers* – it's still a good time to buy, because mortgage rates will still be historically low – lower in 2005 than they will be in later years.
- ***A warning to buyers*** – do not use creative financing to overstretch yourself into buying a property you really can't afford.
 - Think about what your payments ***will be*** several years from now when the introductory period of your mortgage ends, or as the interest rate adjusts.
 - Do not assume or “bet” that you can easily sell or refinance based on automatic price rises of 20% or 25% every year. Forcing yourself into such an optimistic scenario can sting you – because this time it “ain't gonna happen.”
- ***Advice to buyers*** – buy a residence you can live in for several years!
 - A fixed-rate mortgage is preferable (30 or 15 years).
 - Try to put 10% down (20% would be even better).
 - Then you won't have to worry so much about what happens to mortgage rates or to prices over the next few years. You're set. Just live your life and be happy.
- ***Enjoy your home and laugh at the world!***

For further information,

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